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WESTERN EUROPE 1979–2009

A View from the United States

ROBERT A. LEVINE

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RAND

PREFACE

This report was written using research support funds provided by the three RAND federally funded research and development centers for national security studies: the National Defense Research Institute, sponsored by the Office of the Secretary of Defense, the Joint Staff, and the defense agencies; the Arroyo Center, sponsored by the United States Army; and Project AIR FORCE, sponsored by the United States Air Force.

The study is intended to provide a broad economic and political context for the strategies the above agencies are planning with U.S. security partners in Europe, as the 21st century approaches. It should also be of interest to those concerned with the European Monetary Union and with West European economic policies.

CONTENTS

FIGURES

TABLES

SUMMARY

Western Europe may be heading for trouble, trouble that can extend to the United States, for which Western Europe remains the most important economic, political, and security partner.

What the United States needs in Western Europe is, at best, a strong and equal partner and ally; at worst, a region no less stable than it is now. What it is likely to get is, at best, a Western Europe like the current one, with hope for the long-run future; at worst, increasing political as well as economic instability.

The sources of the trouble lie in the West European political economy. The imposition of the highly restrictive Maastricht fiscal and monetary criteria for membership in the European Monetary Union (EMU)—on an economy already twisted out of shape by East German reconstruction—has brought about high unemployment and other harsh realities that have proven politically unacceptable in France and may well do so in Germany. If Maastricht's rigid macroeconomic constraints are relaxed—if EMU balances its stress on inflation control and fiscal rectitude with equal emphasis on employment and growth—then rising unemployment may be reversed in the short run, and conditions can be set for long-run improvement. If not, and if unemployment remains near or above 12 percent, then the worst is yet to come.

EMU: HISTORY

From the post–World War II reconstruction of Europe through the oil crises of the 1970s, the primary goal of economic policy in Western

Europe—and North America as well—was "full employment," which seemed achievable with no more than moderate inflation by use of "Keynesian" macroeconomic stimulus including fiscal deficits when necessary.

The oil shocks changed that. Through the 1970s, it was impossible for any Western economy to reach a satisfactorily low level of unemployment without incurring an unsatisfactorily high rate of inflation, and vice versa. Then, as oil prices came back into line in the early 1980s, Western governments abandoned full-employment goals and Keynesian policies, and concentrated on controlling inflation even at the cost of increasing unemployment. This remained the direction through 1991, the year the European Union adopted the Maastricht amendments. The Maastricht criteria for EMU membership stressed control of inflation, interest, and exchange rates and, as proved to be the touchstone, fiscal control; the key requirement was a budget deficit no greater than 3 percent of gross domestic product (GDP). The criteria included no measures of growth or employment.

The 1991 criteria thus proceeded linearly from the 1970s and 1980s. In the meantime, however, the entire economic as well as political structure of Europe had been revolutionized by the collapse of the Soviet empire in 1989 and the reunification of Germany in 1990.

At the start, economists and businessmen in what had been West Germany united in their belief that the dynamic west German economy could fix what was wrong in the east in a few years, but they were wrong. The task is taking decades and continues to require immense subsidies financed by tax increases and increased deficits. To relieve the inflationary pressure of the latter, the Bundesbank has maintained a tight money policy. The stimulative effects of the deficits have been largely confined to Germany, but Bundesbank monetary policy has subjected the rest of the continent to increasing unemployment. Similar effects have now reached Germany itself.

The combination of the monetary and fiscal constraints imposed by Maastricht and the continuing effects of German reconstruction forced unemployment in France and Italy above 12 percent, with unemployment in Germany rising almost as high by the end of the 1990s. Britain, which by leaving the European monetary system in

1992 and holding back on applying for EMU membership had removed itself from the continental restraints, was doing much better.

EMU: THE PRESENT AND THE FUTURE

The history outlined above differs from the conventional explanation for high European unemployment, which focuses on structural rigidities. The tight requirements of Maastricht are considered necessary to break these rigidities and restore employment.

The structural explanation is not wrong, but it is partial. Western Europe does need extensive structural reform to reduce long-run unemployment. But the exclusive focus on structure fails to account for differences over time—high unemployment is recent, structural rigidity has been around much longer; or among countries—Germany has always been among the most rigid, but only very recently has its unemployment risen to the levels of its neighbors. Even more important, lower unemployment in the short run—achievable through macroeconomic stimulus—is a political prerequisite for needed reform. The French elections of 1997 demonstrated that when they upset a right-wing government that had chosen the structural route while unemployment remained above 12 percent. Nonetheless, EMU remains based on the 1991 Maastricht criteria.

Four alternative futures are conceptually possible as the January 1, 1999 date for EMU start-up approaches:

- Initiation of EMU on schedule under the strictly enforced Maastricht constraints, initiating a period of prosperity throughout Western Europe. This is a fairy tale.
- Initiation of EMU on schedule under the strictly enforced Maastricht constraints, leading to depression and political unrest throughout Europe. This is the worst case.
- De facto collapse or significant postponement of EMU, because of political rejection by France or Germany. This is quite unlikely but still possible.
- Muddling through to an EMU substantially softer and less effective for good or for evil than had been expected. This is the most likely direction, and probably the best to be hoped for.

In the meantime, the European Union has begun processes intended to lead to the admission of several of the formerly Communist and still relatively poor states of Eastern Europe. A successful EMU would facilitate admission, but EMU muddling could both undermine such admissions and be undermined by the processes themselves and the quarrels they will engender.

THE FOUR KEY NATIONS

What actually will happen to EMU will depend on the futures of the four key West European political economies—Germany, France, Italy, and the United Kingdom. In early 1998, the unemployment rates of the three continental nations clustered near 12 percent. Whether individually or collectively through EMU they will be able to combat high unemployment will depend on the interplay of economics and politics in each of the three as well as Britain.

A WORST CASE

The worst scenario is an EMU devoted to strict enforcement of the Maastricht criteria at the cost of high and even increasing unemployment. This would encourage reversion within the member states of EMU toward individual nationalisms. It could lead to extremism and perhaps a forced change of regime in France, increased xenophobia and tensions between east and west in Germany, and retrogression toward instability in Italy. It would be likely to keep Britain out of EMU, turning it away from Europe. The European Union's existing membership would hunker down, postponing the hopes of the eastern nations knocking on the door.

Such an outcome would increase EU mercantilism, raising new barriers against Japan, China, and other developing Asian economies—and against the United States. One likely U.S. reaction would be toward Fortress America, not a Maginot Line but more probably a protected base system—worldwide as much as possible, U.S.-based as necessary—from which American power could sortie to protect its interests and occasionally promote American ideals.

In sum, the unstable equilibrium of the post–World War II world order would be further destabilized.

A WAY OUT

This analysis suggests the need for a redirection of economic policies toward reducing unemployment—directly through macroeconomic stimulus and indirectly by creating the political conditions needed for structural change. EMU would not impede such a move. Because of the impossibility of stimulus—monetary or fiscal—in one country acting alone, it would in fact be a necessity. Under the Maastricht criteria such a redirection would be impossible, but the criteria can be changed—or ignored in practice. Particularly if a German government of the moderate left joins the similar governments of France, Britain, and Italy, the economic necessity may become a political possibility.

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The author wishes to thank his RAND colleagues, Thomas Szayna and Gregory Treverton, as well as former RAND analyst Charles Cooper, for extensive and highly useful comments. The final analyses and conclusions remain the responsibility of the author.

Chapter One

INTRODUCTION

> Without America, Great Britain and France cannot sustain the political balance in Western Europe; Germany would be tempted by nationalism; Russia would lack a global interlocutor. And without Europe, America could turn, psychologically as well as geographically and geopolitically, into an island off the shores of Eurasia.
>
> —Henry Kissinger[1]

This study covers:

- *Western Europe*, the part of the world traditionally closest to the United States, by alliance and by common interests and culture.
- *The period 1979–2009.* January 1, 1999 is the initiation date of the European Monetary Union (EMU), which is supposed to begin a new era in Western Europe. The analysis starts with the configuration of economic and political forces in the years leading up to EMU, and suggests that the new era will be difficult if not dangerous.
- *A view from the United States.* The author is American, which inevitably colors his viewpoint.

The analysis leads to conclusions regarding the results of current policy that are quite pessimistic, for Europe and the United States.

[1]Henry A. Kissinger, *Diplomacy*, Touchstone, New York, 1995, p. 822.

The line of argument is that what the United States needs in Western Europe at the beginning of the 21st century is, at best, a strong and integrated economic, political, and military partner; at worst, a Western Europe no less stable and no more internally at odds with itself than at present. What the Atlantic community is likely to get as a result of the way EMU is being put into place is, at best, a Western Europe like the current one; at worst, economic deterioration leading to significant political weakening.

The sources of the potential troubles lie in political economy. In particular, the imposition of the stringent, superorthodox Maastricht criteria for EMU membership on a European economy twisted out of shape by the costs and failures of East German reconstruction has brought about high unemployment and other harsh realities that have proven politically unacceptable in France and may well do so in Germany too.

Change of direction would be politically difficult but may be possible. If the rigid constraints are relaxed de facto, then the best of the possible worlds characterized above—no deterioration—is achievable and the conditions can be set for long-run improvement. If not, and if unemployment remains near or above 12 percent, then the worst is yet to come.

The next chapter reviews the history of EMU and previews its prospects. This is followed by a discussion of the four key countries—France, Germany, Italy, and the United Kingdom—suggesting that it is no coincidence that the United Kingdom, which veered from economic orthodoxy by devaluation, is much the best off of the four. The study concludes with a brief examination of the political and security as well as the economic implications for Western Europe and for the United States of a worst-case future and a potential better alternative.

Chapter Two

TWO DECADES: FROM MAASTRICHT TO EMU, FROM EMU TO . . . ?

> Great historical transformations are always bought dearly, often after one has already thought that one had got them at a bargain price.
>
> —Jacob Burkhardt

> The treaty negotiators made a political blunder in choosing convergence indicators that are neither the best nor the most appealing . . . and by failing to consider the problems of per capita income and unemployment.
>
> —Christian de Boissieu; Professor of Economics, University of Paris[1]

FROM THEN TO NOW

In December 1991, the European Union (EU) adopted the Maastricht amendments to the Treaty of Rome, the original instrument establishing what was then the European Economic Community. Maastricht's centerpiece was the agreement on the Monetary Union, to begin on January 1, 1999.

[1]Phillip Morris Institute for Public Policy Research, *Beyond Maastricht: The Issues at Stake in the 1996 IGC*, conference proceedings, Paris, France, January 31, 1995, p. 8.

States aspiring to join EMU would be required to meet four conservative criteria requiring their economies to "converge" to: low rates of inflation, similar interest rates, stable exchange rates, and stringent fiscal responsibility measured by public deficits no greater than 3 percent of gross domestic product (GDP). Low unemployment was not included among the criteria, although it was covered equivocally in Article II, which listed the objectives of the agreement:

> balanced development of economic activities, sustainable and non-inflationary growth respecting the environment, a high degree of convergence of economic performance, a high level of employment and of social protection, the raising of the standard of living, and economic and social cohesion.[2]

Less than six years after Maastricht, the French legislative elections of June 1997 threw into doubt the conservative balance of the criteria and, for a while at least, EMU itself. The French voters dumped the center-right government of Prime Minister Alain Juppé, which had been dedicated to imposing the austerities needed to implement what had turned out to be the most difficult of the Maastricht criteria, the 3 percent deficit requirement.

The central issue in the election was the high unemployment rate, hovering around 12 percent. Two years earlier, Jacques Chirac had been elected president in substantial measure on the basis of his promise to reduce unemployment. He made Juppé his prime minister, but when the two then focused on the Maastricht-required austerities, unemployment increased.

Juppé was replaced by Lionel Jospin and a Socialist-led government. Jospin also promised to cut unemployment, but he remains dedicated to the Maastricht Treaty and its criteria, including deficit control. The French hope that the *deus ex machina* of economic growth, based in substantial measure on exports to the strong U.S. and other economies, will help. By the early months of 1998, growth had in fact accelerated, although not enough to reduce unemployment significantly. However, neither the Asian crises nor the negative effects of the expenditure cuts needed for deficit reduction had yet cut in.

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[2]Quoted in Peter B. Kenen, *The EMU After Maastricht*, Group of Thirty, Washington, D.C., 1992, p. 22.

The French election results should not have been unexpected. By 1995, economists such as Professor de Boissieu, quoted above, were pointing out the "political blunder" of Maastricht's failure to include concrete employment considerations to counterbalance the exchange rate, inflation, and deficit criteria. Another French economist, Pierre Jacquet, called for reinterpretation of the *franc fort* that was the centerpiece of the French drive to enter EMU by keeping the franc up with the deutsche mark. He advocated redefining French economic strength to include the creation of "macroeconomic conditions more propitious for the creation of jobs."[3]

So far, nobody in the governments of France or the other EMU states has been listening.

The Question Why?

The key historical question, which must be answered to understand the range of possibilities for the future, might be asked as:

- Why did the Maastricht fathers fail to foresee the difficulties that the stringent and unbalanced criteria would cause?

or

- Why do the politicians and publics of the late 1990s have so much difficulty meeting the reasonable criteria set at the beginning of the decade?

or, in its most neutral formulation,

- What has changed, and what do the changes imply for the future?

Arguably, Maastricht's exclusive focus on price stability and "fiscal responsibility" to the exclusion of employment and unemployment was wrong to begin with, although it was understandable. EMU was designed in another era, at a time when the eastern boundary of Western Europe was the border between the Federal Republic of Germany and the Communist German Democratic Republic; but it

[3]Pierre Jacquet, in "Enjeux," *Les Echos*, Paris, July 1995.

was implemented under vastly different circumstances, when the western part of a unified Germany was undertaking the vast job of reconstructing the eastern part.

Earlier, through the early 1970s, "full employment" had been the priority objective of macroeconomic policy in the Western world, the United States as well as Europe—and for the most part it was achieved at relatively low levels of inflation. In 1973, however, the oil shocks that began with the Yom Kippur War of that year changed this sanguine situation. After October 1973, the price of energy went up so rapidly that nowhere in Western Europe or North America could economists or politicians design a macroeconomic policy that might achieve a satisfactory combination of unemployment and inflation, or, indeed, a satisfactory level of either.

The resulting change was taken by Western politicians and many economists to be a permanent shift in the structure of the world economy. An alternative would have been to treat it as a long hiatus that ended in the early 1980s when oil prices fell sharply. The perception of permanence, however, governed economic decision-making through Maastricht and has continued to do so. The "Stability Pact" signed in Dublin in 1996 was intended to ensure that the stringent rules for entry into EMU continued to constrain national fiscal policies once the Union was actually in business. Whether EMU will in fact operate that way is a crucial question for the future of Western Europe

Table 1 illustrates the formative events. It displays average unemployment and inflation for the four major European economies for three periods: postwar, from 1950 through 1973; the oil-shock decade from 1974 through 1983; and 1984 through 1991, the year of Maastricht. The table shows a drastic deterioration between the first two periods, the postwar era and the oil-shock years. Unemployment, inflation, and therefore the sum of the two, the so-called "misery index," went up sharply in each of the four states. The index almost doubled in Germany; it almost tripled in the United Kingdom; the other two were in between. Largely as a result of this economic deterioration, three of the four governments were overturned in the late 1970s and early 1980s, the left being replaced by the right in Germany and Britain, and the right by the left in France. (In Italy, the

Table 1

Unemployment and Inflation, Major European Economies, 1950–1991

	Unemployment (% of Labor Force)			Inflation (Av. Annual Compound Growth Rate)		
Country	1950–73	1974–83	1984–91	1950–73	1974–83	1984–91
France	2.0	5.7	9.8	5.0	11.2	4.0
West Germany	2.5	4.1	6.0	2.7	4.9	1.8
Italy	5.5	7.2	10.3	3.9	16.7	6.7
United Kingdom	2.8	7.0	9.4	4.6	13.5	5.8

SOURCES: For 1950–1983, Angus Maddison, *Monitoring the World Economy, 1820–1992*, Organization for Economic Cooperation and Development (OECD) Development Centre Studies, Paris, 1995, Table 3.19; for 1984–1991, computed from OECD *Economic Outlook*, June 1996, Annex Tables 16 and 22.

heirs to the Medicis and the Borgias continued the rococo postwar political patterns that had little to do with the Italian economy, much of which operated on the black or gray side, outside of public scrutiny, in any case.)

Additionally, Table 1 shows that in the third period, after the end of the oil-price shocks, the economic decisionmakers of France, Germany, and the United Kingdom focused on inflation, reducing it at the cost of even further increasing unemployment. A central reason for this reversal from the postwar period was that the oil-shock decade had shaken the faith of economists and politicians alike in the Keynesian economic doctrines that had dictated active government macroeconomic stimulus to promote full employment.

In place of Keynesianism, a number of economists proposed the theory of "rational expectations," which purported to demonstrate that stimulus was bound to be dissipated into inflation without any favorable long-term effect on reducing unemployment, because private decisionmakers would learn to anticipate such inflation and try to get ahead of it.[4] In retrospect, this seems a premature general-

[4]See, for example, Thomas Sargent and Neil Wallace, "Rational Expectations, the Optimal Money Instrument, and the Optimal Money Supply Rule," *Journal of Political Economy*, 1975.

ization from the special experience of the oil-soaked 1970s,[5] but in the 1980s, it meant that the anti-inflation stress of the new conservative governments in Germany and Britain received little coherent professional opposition from economists. In Germany, in particular, memories of the hyper-inflation of the early 1920s gave this stress a broad popular base. The French Socialist governments under President François Mitterrand moved initially in the opposite direction, but they could not sustain expansionary macroeconomics under competition from the conservative states around them, and by 1983 France too had turned to the right in macroeconomic policy.

This set the stage for the mind and policy set with which EU entered the Maastricht negotiations for monetary union in 1990–1991. Inflation control was the central concern; employment and unemployment were ignored, facilitated by the fact that by 1990 unemployment had been falling for several years from its highs in the 1980s. France was down to 8.9 percent as compared to its earlier high of 10.5; Germany to 4.8 as compared to 7.1; Italy to 10.3 from 11.0; and Britain to 6.9 from 11.7. Although France and the United Kingdom suffered slight reversals in 1991, this had little effect by the time the Maastricht Treaty was signed in December of that year. The anti-inflation momentum of the 1980s continued to prevail.

Meanwhile, however, Europe had undergone a revolution. In the fall of 1989, the Soviet empire collapsed; at the end of 1991, several days after the signing of the Maastricht Treaty, so did the Soviet Union itself. With one large exception, however, most of the effects lay outside the West European economy. Eastern Europe, including Russia as it moved toward democracy, received strong moral support but relatively little economic assistance.

The exception, of course, was Germany: the Berlin Wall, the instrument and symbol of a divided Germany, came down in November 1989; the ostmark of the German Democratic Republic (GDR) disappeared into the deutsche mark in July of 1990, and by the end of the year, Germany was fully unified, legally.

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[5]For further discussion, see Robert A. Levine and Peter J.E. Stan, *Macroeconomic Strategy for the 1990s: Getting the Long Run Right*, RAND, MR-325-RC, 1993, pp. 24–30.

The ostmark was replaced by the deutsche mark at 1:1 parity, a vast overvaluation of the eastern currency in order to symbolize the full unity of the two parts of Germany and—of more crucial immediate significance—to stop the accelerating migration from east to west that seemed to be gaining momentum. Most German economists and businessmen were critical of the parity decision, but they were nonetheless nearly unanimous in the belief that the wealthy and powerful west German economy could easily absorb the east and reform its Communist structure in a matter of a few years.

They were wrong. The eastern economy produced little that could compete in the markets of western Germany, Western Europe, or the world.[6] By 1995, it was estimated that western Germany had spent one trillion deutsche marks (about $700 billion at then-current exchange rates) on reconstruction.[7] By 1997, as the German economy as a whole slowed down, it was clear that much had been accomplished. The public infrastructure of eastern Germany had been brought up to western standards and retail and wholesale trade had been westernized to satisfy the demand sustained by western German-subsidized eastern German consumption. What remained to be done, however, was even greater: to reconstruct private production of goods and services that could be sold competitively in western Germany and elsewhere, thus making it possible to end the subsidies.

Only part of the heavy cost was covered by increased German taxes. The remainder was financed by increased deficits, and to counter the inflationary effects of those deficits, the Bundesbank kept German money tight. The expansionary effects of the deficits, however, were largely confined to Germany; the European monetary system, dominated by the deutsche mark and the Bundesbank, spread the constraints throughout Western Europe.

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[6]See Charles Cooper and Robert Levine, "The United States and Germany in the World Economy," in Heiner Flassbeck, Wolfgang Gerstenberger, Charles Cooper, and Robert Levine, *The RAND/DIW/IFO Conference on the European Challenge and the Role of the USA*, RAND, CF-107-RC, 1993.

[7]*This Week in German*, June 23, 1995, cited that estimate from the *Suddeutsche Zeitung*.

Table 2 shows the results. The first column in each half of the table, for unemployment and for inflation, is the same as the last column in Table 1, covering the run-up to Maastricht in 1984–1991. The second column shows the immediate post-Maastricht period, from 1992–1995. These are the latest annual data available on a consistent basis, so the third column on each side gives a snapshot of more recent data, for mid-1997.

The individual countries will be discussed in more detail in the next chapter, but what Table 2 shows quite clearly is Maastricht's effect. In each of the economies, inflation was brought under strict control; in each, except for the United Kingdom, this was accomplished at the cost of increasing unemployment. The United Kingdom was able to be different, controlling its own economy by taking the pound out of the European Payment System and indicating that it was not interested in the first round of EMU.

Table 2 also shows why the French overturned their government—steadily increasing unemployment since Maastricht—and why it is not unlikely that the Germans will overturn theirs. The German data for before and after Maastricht are not consistent, covering western Germany only through 1991, but the 3-percentage-point jump from 1992–1995 to mid-1997, similar to the increases in France and Italy, is for all Germany. (In 1997, unemployment in the east was around 25

Table 2

Unemployment and Inflation, Major European Economies, 1984–1997

	Unemployment (% of Labor Force)			Inflation (Av. Annual Compound Growth Rate)		
Country	1984–91	1992–95	mid-1997	1984–91	1992–95	mid-1997
France	9.8	11.5	12.8	4.0	2.0	0.9
Germany[a]	6.0	8.2	11.4	1.8	3.5	1.6
Italy	10.3	11.0	12.2	6.7	4.7	1.6
United Kingdom	9.4	9.7	5.8	5.8	2.8	2.6

SOURCES: For 1984–1991, from Table 1; for 1992–1995, computed from OECD *Economic Outlook*; for mid-1997, from *The Economist*, June 21–27, 1997.

[a]The unemployment figures through 1992 are for West Germany only.

percent, but the east provides only about 18 percent of the German labor force. Unemployment in western Germany had risen to about 9 percent, also a 3-point increase.)

The crucial historical lesson is that the Maastricht constraints, based on the policy assumptions of the pre-Maastricht 1980s, which in turn stemmed from the experience of the oil-shocked 1970s, have perpetuated the same constricting economic structure into the post–Cold War reconstruction era of the 1990s. Applied as designed, they could perpetuate Western Europe's high-unemployment economy into a fourth decade, but the pressures have piled up and the safety valves are beginning to blow.

The Economy of Western Europe Now: The Conventional Explanation

It will be clear to anyone with even a casual familiarity with recent European economics that the above history differs greatly from the standard explanation for the current unhappy situation. Rather than the macroeconomic explanation given here, the standard analysis focuses on the policy-imposed microeconomic structural sclerosis that pervades most of Western Europe, particularly France and Germany. Such analysis compares European unemployment rates with the much lower ones in the more flexible U.S. economy.

In fact, the macroeconomic and microeconomic explanations are each partially correct and complementary. Rigidities exemplified by the difficulty of firing employees in France and Germany, the high costs of social welfare programs in both countries, and government *dirigisme* of the economy (particularly in France), do account for much of the differential unemployment rates in Europe and the United States. For European unemployment to drop to American levels in the long run, the rules will have to become much more flexible and the costs much lower.

However, the structural explanation by itself is insufficient and the proposed structural solutions are not only inadequate but are politically impossible. Europe cannot get "there" from "here," not under current macroeconomic policies.

- *Analytically*, the conventional explanation is static and undifferentiated, explaining neither the changes set out in the above history nor the differences within Europe.

  — The rigidities are not new; the high unemployment is. As put by three economists from the Deutsches Institut für Wirtschaftsforschung (DIW), a major government-supported German economic research institute:

  > Labour-market rigidities in Europe did not strongly increase in the 1970s and the early 1980s. Since the mid 1980s, they have tended to decline. It is therefore difficult to believe that these moderate trends can explain the doubling of the unemployment rate in less than a decade, particularly as structural change did, on average, not accelerate in the 1970s and 1980s.[8]

  — Until recently, experience has differed within Europe, in ways not easily explained. An analysis by four economists from Germany, the United Kingdom, France, and the United States asks:

  > Why has Germany almost always experienced lower unemployment than other countries including the United States? From 1970 up until the last quarter of 1992 the German standardized rate was below or at least close to the U.S. rate. Was the German labor market more flexible than or at least as flexible as the one in the U.S.? . . . Why is Germany much better off than the rest of Europe?[9]

- *Socially*, the rigidities responsible in part for high unemployment are accepted by a majority of European voters as the price for *égalité* and *fraternité*. Aside from the details of specific safety nets,

  > [I]t is now widely recognized that earnings and income inequality have grown substantially in the United States since the 1970s . . .

[8]Fritz Franzmeyer, Ludwig Lindlar, and Harald Trabold, *Does Internationalisation Constrain National Employment and Social Policies?* Deutsches Institut für Wirtschaftsforschung (DIW), Berlin, 1996, p. 17.

[9]Heiner Flassbeck, Brian Henry, Pierre Jacquet, and Robert Levine, "Unemployment in Europe and the U.S.: Macroeconomics is the Key," *Politik und Gesellschaft: International Politics and Society*, April 1997. The author of this study is among the four.

> The United States experienced much greater increases than countries whose governments try to offset the effects of what appear to be strong global and market forces, which, if left unchecked, disproportionately reward the earners of high wages.[10]

Indeed, this might be termed the "Anglo-Saxon" model, since Britain is beginning to exhibit the same benefits of flexibility as the United States, as well as some of the same increases in inequality.

- Most important of all, *politically* the needed structural reforms cannot be instituted at high levels of unemployment. The French elections demonstrated that.

The conventional explanation for Europe's economic problems is not incorrect. But it is partial. As the sole basis for policy—which it has become under the Maastricht rules—it is self-defeating and may lead to substantial economic and political instability.

WHAT HAPPENS NEXT?

EMU remains on the road to January 1, 1999.

France's left-of-center government remains committed to joining EMU and, with the aid of the economy's unexpected growth and fiscal manipulation, submitted a budget close to the 3.0 percent deficit target. If, however, the government's other efforts fail to cut unemployment soon, additional steps to this end could reverse course and increase the actual deficit, but too late to affect EMU entry.

Germany seems unlikely to implement the harsh measures once envisaged to bring the deficit down to a true 3.0 percent—not in an election year, and not with unemployment approaching 12 percent. The Germans, however, are saved by a double dose of favorable timing—one part unplanned, the other quite intended. First, German growth, like the French, has accelerated, in large measure because of increased exports based on U.S. prosperity and the rise of the dollar. The new growth has been insufficient to cut unemployment, but it has reduced the 1997 budget deficit without necessitat-

[10]Franzmeyer, Lindlar, and Trabold, p. 26.

ing unpopular policies. The Asian problems beginning in late 1997, however, may counterbalance the benefits from the Western hemisphere.

The second piece of good timing will remain in any case. The decision date for EMU membership was May 1998; the elections are not until September, leaving four months in which popular decisions may be made or unpopular ones postponed, even though the 1998 deficit may grow as a result.

The same timing and game-playing that allow France and Germany to move plausibly close to the 3 percent goal also opened the door to the entry of southern European countries such as Spain and, particularly, Italy, which have met the same softened criteria in the same ways.

As matters stand, four alternative scenarios seem possible for the period leading up to January 1, 1999 and the several years thereafter:

1. Implementation of EMU on schedule under the strict guidelines of the Stability Pact, continuing the conservatism of Maastricht into the indefinite future—thus initiating a period of prosperity and harmony throughout Western Europe. This is a fairy tale.

2. Implementation of EMU on schedule under the strict guidelines of the Stability Pact, continuing the conservatism of Maastricht into the indefinite future—thereby increasing the chances that Western Europe will enter the third millenium in a state of depression and political unrest. This is the worst case.

3. De facto collapse or significant postponement of EMU, because of political rejection by France or Germany. This is quite unlikely but still possible.

4. Muddling through to a 1999 EMU that is substantially softer and less effective for good or for evil than had been expected. This is the most likely direction, and probably the best that can be hoped for.

1. Original Schedule, Original Design, Original Hopes

Export growth plus fiscal manipulation enabled France and Germany to reduce their 1997 deficits to near 3.0 percent in time for May 1998. Italy, Spain, and smaller nations also met the relaxed criteria, and an 11-state EMU will get under way on January 1, 1999. The new currency, the euro, will substitute fully for national currencies on schedule, in 2002, by which time, under this scenario, the United Kingdom will also have joined.

Following the Maastricht criteria, the new European Central Bank (ECB) in Frankfurt will make inflation control its highest priority, thus continuing de facto the tight money policies of the Bundesbank that have governed Western Europe's macroeconomy during the 1990s. Again conforming with Maastricht, the ECB will not defer to political interventions by EMU's member countries. The Stability Pact will be enforced, applying strong sanctions to any member whose fiscal deficits rise too far above guidelines.

As a result of all this, the countries needing structural reforms will be reinforced in their efforts to promote remedies. The reforms in turn will lead to greater labor-market flexibility and increased competitiveness with the United States and the rest of the world. Unemployment will fall, and Western Europe will enter the third millenium in increasing prosperity and stability.

This is the way most European leaders talk. Their politically necessary optimism has little economic justification.

2. Original Schedule, Original Design, Failed Hopes

Instead of leading to disciplined success, the enforcement of tight money and national fiscal "discipline" leads in this scenario to the end of any possibility for national or international action to reduce unemployment in the near term. Over the long run, unemployment might be reduced by structural means, but national politics would not be likely to allow such structural reforms under these conditions.

Continued high unemployment with little hope of improvement would be a grim economic outlook, likely leading to an equally grim political outlook for Western Europe in the 21st century. Even that is

preferable, however, to what may happen when an inevitable downturn in the business cycle is imposed on an already faltering economy, as occurred in 1929.

3. Collapse or Significant Postponement

Until January 1, 1999, some possibility of postponement or collapse—small but not negligible—will continue to exist.

In France, Prime Minister Jospin is so strongly committed to EMU that reversal is highly unlikely. Jospin's continuing popularity was demonstrated by the success of his supporters in the March 1998 regional elections. But if unemployment remains high through the September *réentrée* of the French from their summer vacations, or if it increases because of Asian crises or internal economic contradictions, support of the Jospin government could drop rapidly. The regional elections have already increased the disarray of the moderate right and increased the power of the far right *Front National*. *Front* maneuvers or autumnal civil disturbances akin to those of December 1995 could throw into question the commitment to EMU, the government, and conceivably even the regime.

In Germany, Chancellor Köhl is so deeply devoted to EMU that he is unlikely to take any step that might endanger it, even at the cost of his reelection. But Köhl is not the entire government or body politic. The Bundesbank and parts of his own coalition are much less committed. The Social Democratic opposition (SPD) favors EMU on the record but without Köhl's fervor; other elements of a potential SPD-led government are dubious at best. The young, without the Nazi-memory-impelled desire to tie Germany into Europe once and for all, are less enthusiastic than older Germans. And polls show that a majority of the electorate opposes the Monetary Union, fearing the demise of the sacred deutsche mark. Most are apparently willing to go along, but significant opposition still exists.

Opposition was exacerbated further in May 1998 by Köhl's perceived giving in to France by allowing the first eight-year presidency of the European Central Bank to be split, with a French banker taking over the second half from the Dutchman favored by the Germans and other Europeans. This was seen—correctly—as a weakening of the independence of ECB from political influence.

In any case, unlikely as it is, as these events play out in the last half of 1998, they could bring about a decision to postpone EMU.

4. Muddling Through

Much the most probable scenario is an EMU start-up on schedule and nominally within the Maastricht and Stability Pact constraints, but with enforcement of the constraints in doubt.

Once Monetary Union is in place on schedule, exhaustion of the temporary measures taken to meet the criteria, new turns of the cyclical wheel, and events in other parts of the world such as Asia, will reraise deficit and other issues. Domestic pressures to reduce unemployment and improve other economic conditions will increase. Member states will be free of the discipline imposed by the need to get under the wire on schedule while retaining a cooperative façade. The French-German quarrel over the ECB presidency and political influence on the Bank and monetary policy was just the first shot in what will be a long battle, even under favorable economic conditions.

Conditions are unlikely to remain favorable, however—they never do. Faced with cyclical downturn or other problems, national governments are likely to try to pursue national economic policies regardless of EMU and the European Central Bank. The Stability Pact provides sanctions against such behavior, and although the sanctions are likely to prove politically impossible to implement, the structure of EMU will probably make such national efforts impotent anyhow. The single currency and single monetary policy will make independent national fiscal policies almost as difficult as they would be if they were attempted by New York and Texas. And while national governments will have more political influence over the ECB than the advocates of Bank "purity" would like, relaxation of monetary policy will nonetheless be difficult to achieve, particularly if economic troubles are initially confined to a few member states.

Meanwhile, as EMU approaches, EU has cranked up admission procedures intended to lead to the membership of several of the formerly Communist and still relatively poor states of Eastern Europe. A successful EMU would facilitate this, but EMU muddling could both undermine such admissions and be undermined by the

admission processes themselves and the quarrels they will inevitably engender.

In an economic steady-state, such "muddling through" might be tolerable. Under adverse conditions, however, EMU may move toward scenario 2—failed hopes, economic collapse, and political danger.

The key policy question is: Can Europe do better? The answer depends in large measure on developments in the four key European states: Germany, France, Italy, and the United Kingdom. Although the latter is not a charter member of EMU, it may hold the key to ultimate success.

Chapter Three

THE POLITICAL ECONOMIES OF THE BIG FOUR

> France is finding itself more and more the trailer of that huge Switzerland that is Germany.
>
> —Jacques Lesourne[1]

> British Foreign Ministers have been guided by what seemed to them to be the immediate interest of the country, without making elaborate calculations for the future.
>
> —Sir Edward Grey[2]

What actually will happen to EMU and to EU will depend on the futures of the four key West European political economies. This chapter discusses the current states of these political economies and their roots, laying the basis for examination of what might happen next. Each of the four countries is treated individually, but a brief comparison of their recent histories sets the stage.

Figure 1 charts the unemployment experience of Germany, France, Italy, and the United Kingdom from 1980—a year toward the end of the oil-shock era when the four were relatively close together—to the present. Several differences are worth observing:

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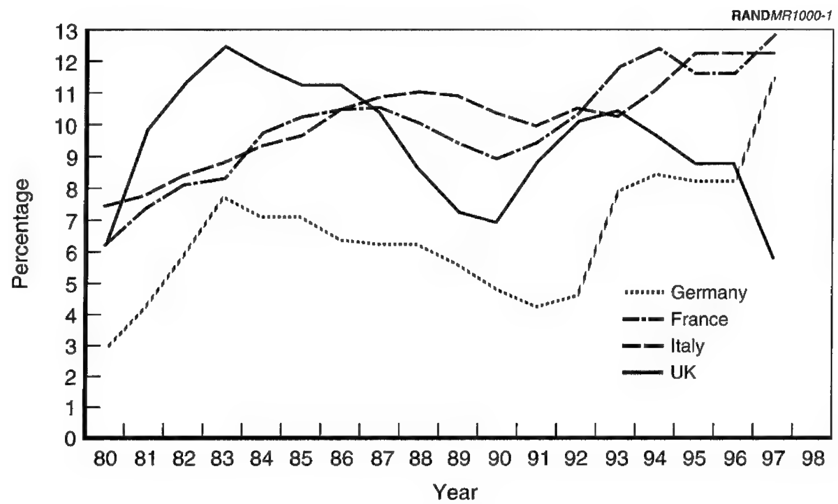
[1]Jacques Lesourne, *Vérités et Mensonges sur le Chômage*, Odile Jacob, Paris, 1995, p. 179.

[2]Quoted in Kissinger, p. 95.



SOURCES: For 1980–1995, *OECD Economic Outlook*, June 1996; for 1997, *The Economist*, June 21–27, 1997.

Figure 1—Unemployment in Germany, France, Italy, and the United Kingdom: 1980–1997

- *From 1980 through 1983, the four economies were very similar.* In 1980, all except Germany were in the 6.0–7.5 percent unemployment range; the German rate was half that. Unemployment then increased in all but at different rates, so that by 1983, a different three of the four clustered in the 7.5–9.0 percent range. The exception was now the United Kingdom, which had unemployment above 12.0 percent. The clustering (the U.S. rate too remained within the central cluster in these years) suggests that world economic phenomena dominated national differences during this period of final adaptation to the oil shocks and then initial adaptation to the end of the shocks.
- *From 1984 through 1990, experience began to diverge.* Unemployment in the United Kingdom and West Germany fell—sharply in Britain, perhaps because of the Thatcher structural reforms, and more modestly in Germany. According to the three

economists from the German DIW, "monetary policies in Europe were, except for Germany and some smaller countries, restrictive for much of the 1980s."[3] France was quite restrictive in large measure in reaction to the early Mitterrand experience; there and in the less coherent and less measurable economy of Italy, unemployment remained high.

- *From 1990 through 1992, unemployment continued to fall in the former West Germany but rose elsewhere.* This was largely because of the uneven effects of the reconstruction of eastern Germany discussed above.
- *After 1992, unemployment in Germany increased and in France and Italy it continued to increase; in the United Kingdom it dropped steadily.* Although the German curve is broken from 1992 to 1993 because of the data changeover from West Germany to all of Germany, it became clear by 1997 that the all-German unemployment rate was catching up to those of its continental partners, and while the German rate in the west remained below the others, it was rising as fast. Britain, having dropped out of the Payment System, devalued the pound and cut the connection between that venerable currency and the deutsche mark, moved happily in the other direction.

In the first months of 1998 as in the early 1980s, the unemployment rates of three of the big four clustered—this time above 10 percent. Tied together by EMU's euro or the deutsche mark, they seemed likely to continue to do so. Whether Germany, France, and Italy will be able, collectively or individually, to combat their high unemployment and the non-economic effects of the economic outcomes will be determined by the interplay of economics and politics in each of the three as well as the United Kingdom. All four nations remain independent, sovereign, and democratic. And to complicate analysis of West European decisions and outcomes, each is on a different electoral schedule.

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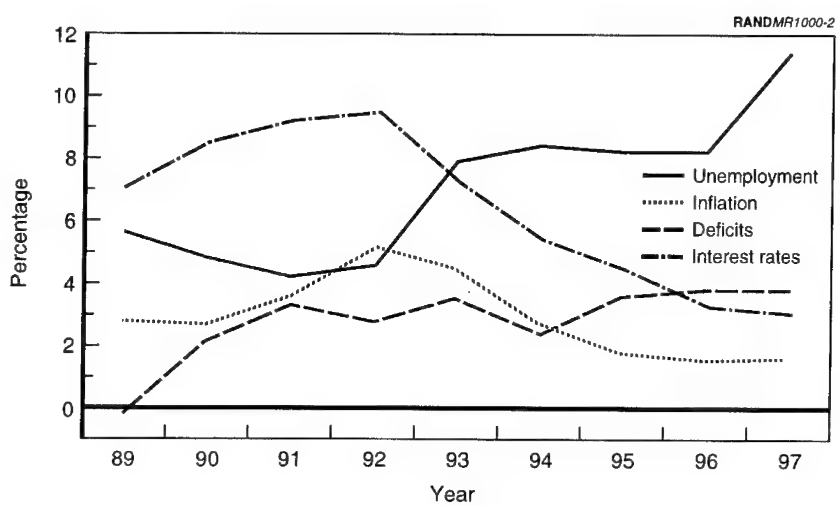
[3]Franzmeyer, Lindlar, and Trabold, p. 22.

GERMANY

Figure 2 charts the four economic variables for Germany most relevant for examining the present and the future—from unification in 1989 through 1997. Two of the curves, unemployment (which breaks for the changeover from West German to all-German data from 1992–1993) and inflation, show the outcomes of the interplay between private economic activity and public policy. The other two, fiscal deficits and short-term interest rates, are largely policy-determined, the latter by the Bundesbank.

Short as it is, the period can be divided into three segments:

- 1989–1991: dominated by *optimism* about reunification and reconstruction of the east German economy.
- 1992–1995: years of greater *realism* about the enormity of the job.



SOURCES: For 1989–1995, *OECD Economic Outlook*, June 1996; for 1997, *The Economist*, June 21–27, 1997.

Figure 2—German Unemployment, Inflation, Deficits, and Interest: 1989–1997

- 1996–1997: *pessimism* as unemployment turned sharply upward, reconstruction stalled, and the deficit initially seemed impossible to bring within the Maastricht limits. Toward the end of the period, export-impelled growth appeared to help with the deficit but not much with unemployment.

The most important period of all, the future, does not appear in the historical chart.

1989–1991: Optimism

The fall of the Berlin Wall in November 1989 led to a period of euphoria in Germany, west and east. In spite of international doubts it was clear to Chancellor Köhl and the German people that the nation would be reunified quickly, and indeed, political unification was accomplished within a year.

Economic unification was going to be more difficult, but this too could be done. The west German economy was the strongest in Europe and sometimes seemed to be able to outcompete the United States; the east was obviously much weaker, but still, the German Democratic Republic had had the strongest economy in the Soviet bloc.

An immediate problem that began with the first breach in the Wall was the building wave of migration from eastern to western Germany. The disappearance of the Wall and the other obstacles to migration also removed most of the political incentives for such movement; the major cause of the migration was now economic—the vast difference in living standards between east and west. Both to lessen this economic incentive and to avoid creating a reunified Germany as a nation with one section very rich and the other very poor, the Köhl government quickly brought the east into the western currency zone. On July 1, 1990, even before formal political unification, deutsche marks were substituted for ostmarks on a 1:1 basis.

Currency unification at parity was accepted but criticized by most west German economists and businessmen because the consequent immense overvaluation of eastern wages priced eastern workers out of competition, given the much lower eastern labor productivity. The immediate aspects of this problem were meliorated in the short

run, however, by large wage and other subsidies, creation of heavily subsidized public jobs, and the consumption and consequent retail/wholesale trade boom based on the sudden enrichment of the easterners because of the currency conversion. To handle the more fundamental changes, the government set up an agency, the Treuhand, to manage the privatization of industries that had been owned by the Communist regime.

As shown in Figure 2, these actions caused the deficit to rise considerably in spite of partial financing by the imposition of a unification tax. The Bundesbank compensated for the pressures of the growing deficit by raising interest rates, and inflation continued its stately decline while German unemployment in the west increased slightly and perhaps only cyclically.

Taxpayers grumbled over the increases, economists and businessmen grumbled over the bad economics of the currency conversion, but all seemed well and on the way to solution. West German economic strength would overcome the legacy of Communism.

1992–1995: Realism

By 1992, it was becoming clear that all wasn't well.

The easy aspects of reconstruction were well under way: the transportation and communications infrastructure of the east was being brought up to western standards, and doing so created many jobs; East Berlin was being brought back to its former glory; retail and wholesale trade networks were coming into place. East German towns were beginning to look like their western counterparts; Leipzig, already an economic showcase for the east, was brought further toward western appearances; even Dresden, much of which had been left in ruins after the Allied bombing of 1945, began rebuilding.

But the economic basis of the east—steel and chemicals and other heavy industry—was hopeless by world standards. Eastern industries could not compete at parity wages, and they probably could not compete under any circumstances. Treuhand could not change that. Jobs for most of those who had worked in these sectors had to be heavily subsidized and real unemployment remained extremely high.

Progress was agonizingly slow; those who had been realistic enough to suggest that the task of economic reconstruction could take as long as ten years were adding another decade. No prospect was in sight for lightening the burden on west German taxpayers.

In addition, the social aspects of reunification were proving far more difficult than had been foreseen in the "*Ein Volk*" delirium of the first days of unification. After almost five decades of vastly different government and social systems, the German *volk* was no longer really one nation. The "*ossis*" of eastern Germany mourned the loss of the security guarantees and community support they had had under Communism, and they resented the condescending attitude of the west German "*wessis*." The *wessis* objected to the increased taxes they had to pay to support the "slothful" habits of the *ossis*.

Neither the difficulties of reconstruction nor the social discomforts had much effect on macroeconomic conditions or macroeconomic policy from 1992 to 1995–1996, however. Unemployment in western Germany began to increase, but only gradually; inflation blipped up in 1992 and 1993, but then came back down to below its previous levels. The deficit, which had risen sharply to finance reconstruction, leveled off, fluctuating around 3 percent of GDP. Once inflation came back under control, the Bundesbank gradually lowered interest rates, although not as fast as Germany's partners in Europe or its competitors in North America would have liked.

1996–1997: Pessimism

In 1996, things began to come apart. Reconstruction was getting nowhere, and unemployment shot up in both parts of Germany, crossing the 10 percent mark for the country as a whole by 1997. Although inflation remained historically low, neither the Köhl government's fiscal policy nor the Bundesbank's monetary policy reduced unemployment. Bundesbank Director Hans Tietmeyer was quite explicit about price stability being his sole focus; unemployment was none of his business.

Getting within the EMU constraints by decision year 1998 became the primary focus of German macroeconomic policy, reinforced by the microeconomic approach to reducing unemployment—cutting social benefits and increasing labor market flexibility. Well into 1996,

German politicians, financiers, and economists had debated whether the 3 percent deficit criterion could be stretched to allow French entry at a few tenths of a percentage point above that figure. Although it was clear that without France there would be no EMU, the Bundesbank and other advocates of monetary and fiscal conservatism were alleged to not much care. Public opinion was against EMU; only the Köhl government was passionately in favor.

By the end of 1996, however, it began to appear that Germany was going to have as much difficulty getting its deficit down as was France, and perhaps even irresponsible Italy. The government responded by proposing a series of steps ranging from the stringent to the bizarre. Few were put into effect. Proposals to cut social benefits to reduce the deficit proved to be so unpopular as to be politically impossible, as did various tax reforms. German street demonstrations were polite compared with those in France a year earlier, but the fact that they occurred at all was significant. Together with the power of the unions and the fact that the SPD and its allies controlled the upper house of the legislature, popular opposition brought about fiscal stasis. Finance Minister Theo Waigel proposed reducing the deficit by the simple device of revaluing the gold in the Bundesbank's vaults, but he was scowled down by Tietmeyer and laughed out by everyone else.

In the late summer of 1997, growth accelerated slightly. This made the 3 percent deficit appear realistic without requiring further fiscal manipulation. It was insufficient to cut unemployment, however. And it scared the Bundesbank into raising interest rates, making significant reduction of unemployment even less likely.

Through 1997, two matters became clear. First, even with the *deus ex machina* of exports, the Köhl government would have to join its European partners in deciding whether and how to adopt some variant of the "muddling through" approach to EMU. Second, nothing being done in Germany was going to reduce unemployment in the short run. All that might be hoped for would be an overflow from the booming American economy—if it continued to boom, and if Asian collapse did not counterbalance it.

The Future

Germany's economic situation as it approaches the 1998 election is not what might be desired by an incumbent government. Indeed, in mid-1998, the level of unemployment and the weakness of the government make an SPD victory seem likely. The early polls as well as the political/economic logic point to a plurality for the Socialists under the leadership of Lower Saxony President Gerhard Schröder, who seems to exude the same left-but-middle-of-the-road attractions of Bill Clinton and Tony Blair.

Whoever wins, however, the dilemma is that in times of economic stress, German public opinion turns to the revered deutsche mark—but conservative policies to strengthen the deutsche mark can cause further contraction. Whether implemented by rigorously decreased budget deficits or increasing interest rates, such policies are likely to further increase unemployment. Fortunately for the Germans, the dilemma grows a third horn (perhaps making it into a trilemma), because the same opinion will not allow benefit- and thus deficit-reducing policies in many cases.

How Germany—and EMU—will come out of this is uncertain. Least likely is that the Köhl government will campaign on the acceptance of high unemployment, the necessity for reducing benefits, and the priority of starting EMU on time—and win. Lacking that, but lacking also any expression by a major government or opposition party of a belief that the way to combat unemployment is to *weaken* the deutsche mark and lessen the conservative rigors of EMU by initiating expansionary macroeconomic policies, the campaign is unlikely to be edifying. Politicians on both sides will express logically contradictory views in a single paragraph of a single speech—a phenomenon not peculiar to Germany.

If Köhl and his coalition are returned, Germany is likely to lead the "muddle through" to January 1, 1999. But if the coalition wins without Köhl, or if he retires soon after election with the old government replaced by younger members of the coalition parties, EMU will still come in on schedule, but implementation of the Stability Pact is less certain. A renewed right-center coalition might well lead an attempt to enforce the Pact and to maintain the Bundesbank-like indepen-

dence of the European Central Bank, but that could bring strong resistance by France, and a conflicted future.

If the center-right is defeated by an SPD-led left coalition, Germany's direction is likely to become even less clear; the model of France's Jospin-left government provides little hope. One possibility, discussed further in the conclusion to this report, may be the joining of Germany's moderate-left government with those of France, Italy, and perhaps eventually the United Kingdom, to readjust the goals of EMU toward encouragement of employment and growth—without, of course, admitting that this might imply a weakening of the euro.

And if the Party of Democratic Socialism—essentially the former East German Communists, with whom neither SPD nor anyone else will join—gets enough votes to preclude either a left-center or a right-center majority in the Bundestag, the likely result will be a left/right grand coalition—a near-perfect architectural design for muddle.

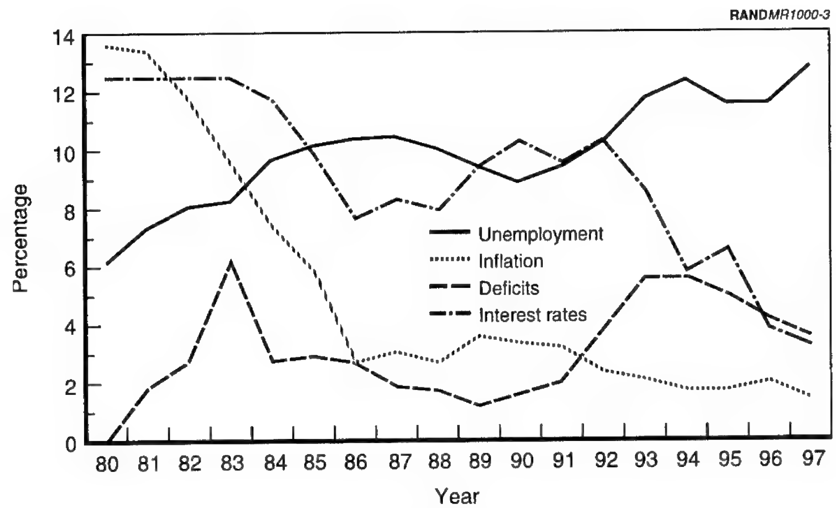
No matter what the actual outcome, however, without radical anti-unemployment action (and none is now on the horizon), Germany is not likely to enter the next decade/century/millenium leading Europe to a strong and confident economy.

FRANCE

The major events that continue to shape French economics antedate the 1989 reunification that changed the course of Germany's political economy. As with the other Western economies, France's plight can be traced back to the oil shocks of the 1970s. France reacted differently from the others, however; the various French policies failed, in part because they were different; and the failure has been at the root of what has become the growing French *malaise.*

Figure 3 charts the two outcome variables—unemployment and inflation—and the two policy variables—deficits and short-term interest rates—for the entire period, 1980–1997.

Although the period can be divided into four segments, the *malaise* itself provides a constant underlying theme that continues across what will soon be two decades. The four subperiods are:



SOURCES: For 1980–1995, *OECD Economic Outlook*, June 1996; for 1997, *The Economist*, June 21–27, 1997.

Figure 3—French Unemployment, Inflation, Deficits, and Interest: 1980–1997

- 1981–1982, *radicalism*, beginning with the election of François Mitterrand as the first Socialist president of the Fifth Republic, and continuing into Mitterrand's second year. France set out on a course that combined doctrinal socialist nationalization and stimulative Keynesian macroeconomics. In 1982, it became clear that these policies had failed.
- 1983–1990, *reversal.* Mitterrand had to change sharply from expansion to austerity to save the French economy from disaster.
- 1991–1995, German reunification and the EMU treaty introduced a period of additional *constraints* stemming from Bundesbank attempts to control inflation and from the Maastricht requirements.
- 1996–?, the gray *present and future* of reaction to 12 years of austerity and constraints. This period opened with the December 1995 strikes that almost brought France to its knees, and continued with the victory of the left in the 1997 legislative elections.

The elections began a period of *cohabitation* of the Jospin government with the Chirac presidency, scheduled to last until 2002.

1981–1982: Radicalism

In 1981, François Mitterrand was elected the first Socialist president of the Fifth Republic. He dissolved the National Assembly, and the electorate obliged him with a Socialist majority in the new Chamber of Deputies. The Socialist government (with a few Communists) was led by Prime Minister Pierre Mauroy.

Mitterrand and Mauroy embarked on a radical course. Following the tenets of classical socialism, banks and industrial firms were nationalized. Macroeconomically, the policy was that of stimulus: the budget was increased by more than 25 percent, and the deficit rose sharply, reaching 2.8 percent of GDP in 1982 and then 6.2 percent the next year, as shown in Figure 3.

Arguably, these may have been the wrong policies for any time, but in any case, they proved to be wrong for that time, for at least two reasons.

- France came out of the oil-shock years with unemployment that was not high by world standards (although it was above previous French postwar unemployment rates), but with very high inflation. In 1980, the year before Mitterrand's election, unemployment was 6.2 percent, inflation 13.6 percent. Although, in principle, Keynesian economics can be restrictive when appropriate, that was not the course taken by the new Socialist regime. Their attempted stimulus did nothing to reduce unemployment in the tight economy. To the contrary, together with nationalization and other structural impositions, they stimulated business fears, and unemployment increased.
- As noted, the effects of the oil shocks overturned governments throughout the West. Only France had had a right-wing government in the 1970s, so only in France did the overturn lead to a left-wing government in the 1980s. In Germany, by then very much the dominant economy of the European Economic Community (EEC), Köhl replaced Socialist Helmut Schmidt as chancellor; Margaret Thatcher ousted Labourite James Callaghan in

> the United Kingdom. In the international trade arena, the economics of deflation championed by Köhl and Thatcher outcompeted the inflationary policies tried by Mitterrand and Mauroy, and French Socialism could not win.

By the end of 1982, the franc had been devalued twice (with a third devaluation in 1983). The government tried to avoid the inevitable by freezing prices and wages temporarily and by imposing restrictions on capital and currency flows, but these actions provided little help. Mitterrand was forced to reverse course sharply, conforming to the conservative norms of his European partners.

French economic policy still reverberates to the traumas of the early 1980s. (Since some continuing French controversies have their roots in the 1780s, this is hardly surprising.)

1983–1990: Reversal

The government was forced to substitute restraint for stimulus. Income taxes were increased as were many consumer taxes; social expenditures were reduced; and prices for public services were increased. As shown in Figure 3, the deficit was brought back down to 2.8 percent of GDP in 1984; interest rates, which had been high to restrain inflation, began to fall; unemployment rose.

This did not make French voters happy, and in 1986 they replaced the left-wing majority in the National Assembly with a right-wing coalition. Jacques Chirac became prime minister, and because of the peculiar Fifth Republic election cycle that combines a seven-year presidential term with a requirement for legislative elections at least every five years, the first period of *cohabitation* began, coupling the Socialist president with a rightist prime minister and government.

Since the outgoing Socialist government had already reversed course, the political change brought about no dramatic redirection in economic policy. The deficit and interest rates continued down, unemployment levelled off and then dropped slightly, and inflation dropped sharply.

Political credit for the improvements went not to the new right-wing government but to the incumbent president, and in 1988 Mitterrand

was reelected handily, beating down a challenge from Chirac. He dissolved the Assembly, and the electorate provided him with a new leftist majority.

The majority was strong enough to last until the next scheduled elections in 1993, but German reunification in 1990 and the signing of the EMU treaty in 1991 imposed new constraints on French economic policy.

1991–1995: Constraints

The effects of reunification on German deficits and the consequent efforts of the Bundesbank to control German inflation through monetary policies that reverberated throughout Europe have already been discussed. As Figure 3 shows, French short-term interest rates rose from 7.9 percent in 1988 to ±10 percent in 1990–1992. Partly as a result, inflation dropped to historical lows, but unemployment, which in 1990 had fallen below 9 percent for the first time since Mitterrand's retreat to restrictive economics, began to rise again. Deficits too began to rise sharply, largely as a result of the economic slowdown.

The scheduled 1993 legislative elections again reversed the makeup of the National Assembly, bringing in a strong right-wing majority, a new government headed by Edouard Balladur, and a new period of *cohabitation*, again of Socialist President Mitterrand and a conservative prime minister. As time advanced toward the 1998 decision year for EMU, Balladur became increasingly concerned with the deficit, which had reached 5.6 percent of GDP in 1994 and 1995, far above the Maastricht requirement of 3 percent. His government began the long process of deficit reduction, but could not combine that with reduced unemployment, which hovered just below 12 percent.

The 1995 presidential election started out as a three-way affair. An ill Mitterrand was retiring after 14 years, leaving behind him a weak and divided Socialist Party. Two rightists, Balladur and Chirac, ran for the presidency, as did Lionel Jospin for the Socialists. Under the French system, in which lack of a majority in the first round brings about a second round between the two leaders, it seemed possible that Jospin, perceived as a weak candidate of a weak party, would come in third, leading to a runoff between the two conservatives. He

came in first, however, and Balladur dropped out. The right wing then united for the runoff and elected Chirac.

Chirac had campaigned on a platform that emphasized reduction of unemployment (as did, of course, the other two candidates, but Balladur was weakened by the fact that he had failed to reduce it in his two years as prime minister). Chirac made Alain Juppé his prime minister, and the two rededicated themselves to the fight against unemployment.

At the same time, they also dedicated the government to reducing the deficit to Maastricht's 3-percent requirement, which made impossible any short-term efforts at unemployment reduction, other than jawboning. Rather, they argued that the high level of unemployment resulted from the strangling structural restrictions on the French economy, and set about to relax many of these. In November 1995, Juppé announced to the National Assembly a series of measures to close the social security deficit, raise some taxes, reduce various benefits, and reduce the pension rights of groups of public employees, notably those of the railway system. The consequence was near-chaos.

1996–?: The Future

As a result of Juppé's announcement, rail workers, Paris subway employees, and many others went on strike. Transport was frozen. People went to their jobs by foot, by bicycle, by boat, and by traffic jam. In spite of the inconvenience and the fact that the rail workers were striking to preserve special benefits not available to others and going back 100 years, a majority of the French, dissatisfied with high unemployment and nonfunctioning policy, supported the strikers.

By the new year, 1996, the government had folded on most of the key issues and the strikes ground to an exhausted halt. Unemployment for 1996 remained above 11 percent, but the deficit continued to fall toward Maastricht levels. In November, truck drivers tied up the road transport system to gain earlier retirement; they also received popular support, and the government again ended the strike by surrendering. *Malaise* became a popularly discussed issue.

Five-year legislative elections were not scheduled until 1998, also the year of decision for EMU, and Chirac was afraid that matters would deteriorate even further. For that reason, and to gain the advantage of surprise, he suddenly dissolved the Assembly and called for early elections in May 1997, a move supported by Juppé. With unemployment having risen above 12 percent and *malaise* being the word of the day, most politicians would have waited in the hope that things might get better the next year. Most politicians would have been right—the government lost. The Socialists and their immediate allies did not win an absolute majority; they required the votes of the Communists, but that sufficed to form a new government with a few Communist ministers.

Jospin became prime minister, beginning a new period of *cohabitation*—this time a conservative president with a left-wing government. Jospin too made reduction of unemployment his central goal, but he also announced his intention of reducing the deficit to within Maastricht limits. The two goals seemed contradictory, and the initial steps both contradictory and relatively weak in both directions, as Jospin attempted, in EU meetings soon after his election, to make EMU more flexible, and then retreated in the face of rigid German opposition.

As in Germany, French growth in late 1997 benefited from increased exports, but with little effect on reducing unemployment. The lack of further increases in joblessness, however, together with the perception that the new government was trying to do something, combined with the disarray in the defeated right to maintain Jospin's popularity. The left kept its votes in the regional elections of March 1998; ominously, however, the center-right in some regions struck tacit deals with the extreme-right *Front National* in order to stay in power.

The political economy in 1998 was further confused by a government attempt to reduce the work week from 39 to 35 hours without reduction in pay, a step furiously opposed by French employers and derided by most French economists.

Jospin remains popular, at least on style, but over the next year, as unemployment remains high and EMU comes into being, what the

government and what the French people will do remains unclear. Some of the possibilities include:

- De facto abandonment of the Maastricht rules and the Stability Pact in order to take dramatic steps to reduce unemployment. This possibility would be constrained, however, by the single currency and monetary policy.
- Government failure, perhaps even sufficient to enable Chirac to dissolve the Assembly again (as he can, starting a year after the June 1997 election). Such a political move would require the right to get its act together, which seems unlikely.
- Instability leading to continued gains for the *Front National.* Although anything close to a majority for the *Front* seems extremely unlikely, it could become a major power factor as presaged by its 1998 regional coalitions. If both the center-left and the center-right are seen as having failed to solve the unemployment problem, the *Front* could gain significant additional votes and power.
- New strikes and demonstrations building from the level of late 1995 toward the revolt of 1998 that put an end to Charles de Gaulle's political power. France does not lack a tradition of changing regimes as well as governments in the street.

None of these bodes well for EMU. None, except perhaps the first, bodes well for France. Underlying them all is the *malaise* that led to Mitterrand's 1981 election and has continued, with few breaks, since.

The French *Malaise*

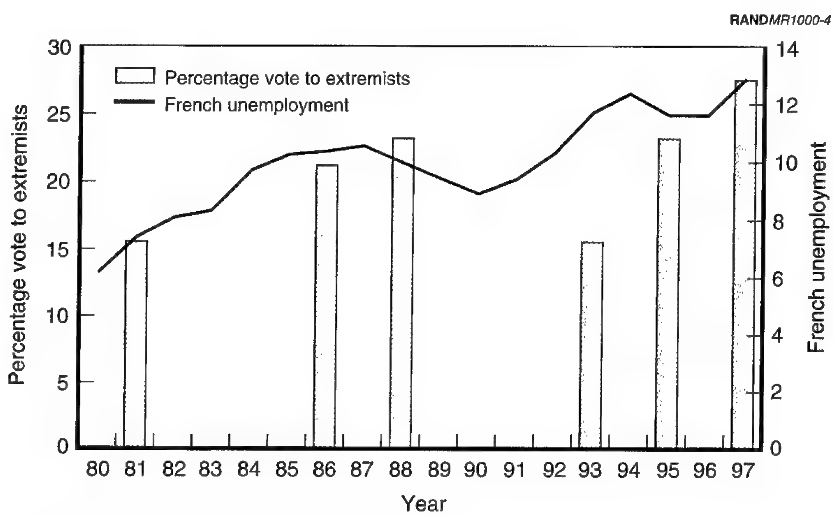
Table 3 and Figure 4 illustrate different aspects of the *malaise.* Table 3 shows the outcomes of every national election held in France during the 1980s and 1990s. What is striking is that the only *re*election in the two decades was that of Mitterrand in 1988, and unless the electorate had taken the unusual step of contradictory reversals—to the right on the presidency and to the left in the legislative elections—one reelection out of two possibilities was inevitable in that year.

Such an alternation is not a sign of a satisfied society.

Table 3

French Election Outcomes, 1981–1997

Year	Type of Election	Result
1981	Presidential Legislative	Mitterrand beats incumbent Giscard Left wing replaces right
1986	Legislative	Right wing replaces left
1988	Presidential Legislative	Mitterrand reelected Left wing replaces right
1993	Legislative	Right wing replaces left
1995	Presidential	Right-wing Chirac replaces left-wing Mitterrand, beating left-wing Jospin
1997	Legislative	Left wing replaces right



SOURCE: *Quid*, Robert Lafont, Paris. 1997.

Figure 4—French Unemployment and Percentage of Vote Going to Extremists

Perhaps even more revealing, however, is Figure 4, which shows (on different scales) the unemployment rate and the percentage of votes going to extremists in the first round during the same period.[4]

"Extremists" are defined as Communists and others whom the French officially define as "Extreme Left" on that end of the spectrum, and the *Front National* and the "Extreme Right" on the other end. It is common, in France as elsewhere, for disaffected voters to flip back and forth from one extreme to the other rather than following the linear right-left spectrum of political philosophers, so the sum of both extremes may be taken as a measure of total disapprobation.

Figure 4 shows two phenomena. First, the trend of extreme voting has been upward: from 15.6 percent in the legislative elections of 1981 to 27.5 in the legislative elections of 1997. Second, the percentage of extreme votes tracks closely the unemployment rate, with perhaps a year's lag. The increasing unemployment of 1997 may or may not have been reflected in the vote of that year, but perhaps optimistically, one might guess that unless the unemployment rate rises, extremism may not go above one-third of the total vote.

Perhaps. On the other hand, with high unemployment, disaffection is likely to accelerate. It is clear that the French electorate is unhappy with the French economy. More than one-quarter voted at the extremes in 1997. Perhaps more important, abstentions increased sharply. Together, the extreme votes and the abstentions illustrate the growing French *anomie.*

As expressed by an editorial in a major regional newspaper:

> the left and the right, which have alternatively shared power, represent hardly 40 per cent of the electorate.... This is not astonishing. The successive alternatives, at different levels of power, have convinced the French that on the major issues which concern them—

[4]The source is the 1997 *Quid* (Robert Lafont, Paris), a semi-official French equivalent of the *World Almanac.* For 1981 and 1988, which had both presidential and legislative elections, Figure 4 averages the results in the two, which were quite close. The first round is used because most of the extreme candidates are forced to drop out in the second round.

unemployment, taxes, insecurity—right and left are equally incapable of finding solutions.[5]

This is not a stable situation, with or without EMU.

ITALY

Economically, Italy is one of Europe's big four, in the rank second only to Germany. Italian GDP is close to that of Great Britain and both are slightly below France, but that difference can be attributed to the 1994 devaluation of the lire and the pound, which lowered the nominal value of Italian and British GDP relative to that of the French. All three are about three-quarters of German GDP.[6]

Yet France and Britain are major economic players; Italy is an afterthought, with its membership in EMU seemingly subject to German whim. The reason, of course, is political. Until very recently, Italy has not had a governing system capable of being taken seriously, internationally or internally. This is now changing. The changes suffice to place Italy among the charter members of EMU on January 1, 1999, perhaps even to make Italy one of the four major states controlling the Monetary Union.

Italy's political economy during the half-century from the end of World War II to the 1994 beginning of the break with the political past presents a major paradox. On the one hand, its renaissance politics has precluded Italy from fighting its weight in international economic and other institutions. On the other hand, the lack of real governance may have permitted and even encouraged the vigorous private economic growth that has brought Italy to its high level of prosperity.

In any case, 1994 was a crucial year, and Italian economic history can be broken into two periods:

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[5]Laurent Gilardino, "The Other Analysis: Everyone Loses," *Le Provence*, March 17, 1998, p. 1.

[6]The data are from the *World Almanac* for 1997 (World Almanac Books, Mahwah, New Jersey, 1997), which provides 1994 data for Germany, France, and Italy, 1993 for the United Kingdom, a difference that does not affect the orders of magnitude discussed here.

- Before 1994
- After 1994.

A.D. 476–1994: Diffusion and Confusion

During the millenium and a half from the fall of the Roman empire to *risorgimento* and unification in the last half of the 19th century, the Italian peninsula was a kaleidoscope of kingdoms, duchies, city-states, and other forms, some peculiar to Italy. From 1860 to 1922, Italy was a state, but a weakly governed one, reflecting in part the lack of a tradition of unified administration. This was a major reason that Fascist rule came to Italy in 1922, a decade earlier than Nazism captured Germany.

During the first part of his Fascist regime, Mussolini imposed a government of apparent strength and efficiency. Even in the Anglo-Saxon countries, a number of admirers not ordinarily attracted to authoritarianism thought that perhaps Mussolini's discipline was needed to impose efficiency on the slothful Italians ("He made the trains run on time"). Beginning with Italy's difficulties in the 1936 invasion of Ethiopia, however, it became increasingly clear that the most-vaunted aspect of Fascism, its military power, illustrated not only its feet of clay but its entire soft understructure. Compared with Germany's efficient totalitarianism, Italy remained in its historical pattern of stumbling governance.

Mussolini fell in 1943, and with the end of the war Italy entered the truly democratic but truly ineffective governmental form it maintained for 50 years. The regime was ineffective except for its one central purpose: to maintain a democratic centrist majority against the small threat of the revival of Fascism and the sometimes much greater threat of Soviet-sponsored Communism. This entailed frequent changes of government and shifting coalitions dominated by the Holy See-backed Christian Democrats, but reaching left as far as the Socialists when they broke their early links with the Communists.

By the early 1980s, the Communist threat had receded, but the pattern continued. Starting with the *Tangentopoli* revelations of 1994, it was a pattern of high corruption, particularly after the Communist threat to Italy faded and then the Cold War ended. Once the revela-

tions made public the extent of what most Italians already knew, the corruption became intolerable, and Italy began its peaceful political revolution, throwing out all the old political parties and almost all the old politicians, and attempting to build a new constitutional structure to prevent recurrence of the old games.

The politics of the old regime was based on a set of rules for economic and other activity so intricate that they required a huge bureaucracy to administer them. The paradox is that the rules and the bureaucratic weight would have ground Italy to a full stop had they been taken seriously. Instead, bribes and other multifarious forms of corruption made it possible for those with money to dispense it to carry out whatever they wanted. The money was dispensed, the bureaucratically hobbled economy was de facto free, and Italy grew nicely.

Northern Italians claim that they have created the single most prosperous region of Europe. Those who say this, particularly the rather sparse northern separatists who advocate the establishment of a "Republic of Padana," contend that southern Italy—the Mezzogiorno—drags down the national economy and statistics. That is true, but it is a limited truth. For one thing, the Mezzogiorno provides much of the public infrastructure for the north. For better or worse, southerners move up the peninsula to man many of the bureaucratic posts, and while Italy surely needs fewer bureaucrats, it needs some and trying to recruit northern postmen and schoolteachers in the tight-employment economy would present many problems.

Additionally, the gray economy of the south—private activity off the books and off the tax rolls—provides much of the equipment and many of the parts that have enabled the industries of the north to remain competitive. And since the gray economy is not reported, the statistics themselves, for the Mezzogiorno and for all of Italy, may be somewhat misleading. Reality in the south is still rather dismal, but it is only gray, not as black, as is sometimes painted.

In any case, change—if it is taken all the way, revolutionary change—has begun. It is probably the case that the Italian economy as well as the Italian polity have reached the point where thoroughgoing re-

form is necessary for further advance. But abandoning the lubrication of corruption will also have its costs.

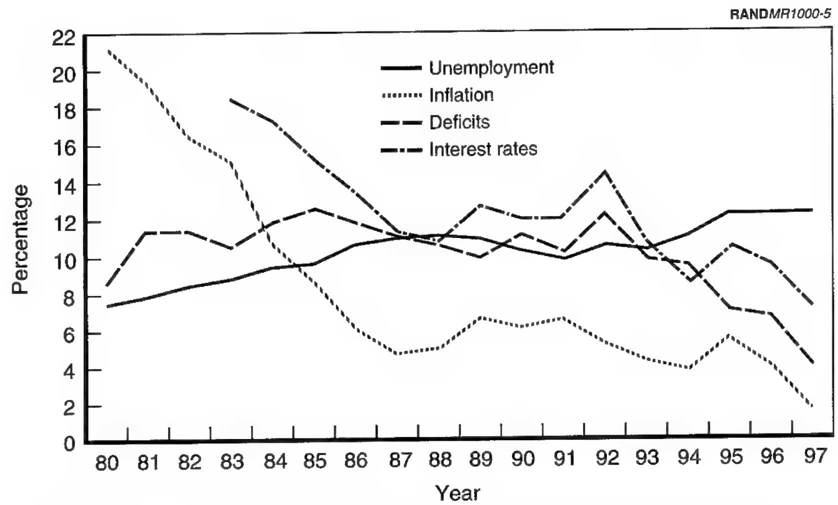
1994–?: The Future

Figure 5 shows the two output magnitudes—unemployment and inflation—and the two input magnitudes—deficits and interests—for 1980–1997.

Bearing in mind that, for the reasons discussed above, the data, particularly for unemployment, are less certain even than ordinary aggregated statistics, Figure 5 shows the path of the old political economy and the beginning of the recent changes. As shown in Figure 1, Italy's unemployment rate stayed close to that of France, except that it did not drop in the late 1980s (statistical artifact?), so that the current high rate is less of an increase than in France. Inflation, which was over 20 percent in 1980, was brought down sharply because it had to be, but throughout the old regime it stayed significantly above the rates in the other major economies. So did the Italian deficit; so did interest rates, to cope with the deficit and control inflation.

In 1994, the *ancien regime* crumbled, not quite as fast as the Berlin Wall, but just as thoroughly. It became clear, initially through the investigations of magistrates in Milan, that almost every Italian politician from prime ministers on down had been on the take; almost every important businessman had been on the give and/or the take. Made public and official, these facts, which had been "sort of known" by most Italians, became intolerable.

In a movement that is not yet complete, Italy began to change constitutional and electoral forms. Even more important for the economic future, the political parties that had managed the old smoke-and-mirrors political economy disappeared. The two major government parties, the Christian Democrats and the Socialists, went out of existence, as did smaller allies that had been part of the shifting coalitions. The Communists, already revolutionized by the end of the Cold War, had long been complicit in the cozy corruption. As in other parts of Western Europe, they broke into a larger, reformed, essentially Social Democratic portion, and a smaller group of unrepentant old-liners.



SOURCES: For 1980–1995, *OECD Economic Outlook*, June 1996; for 1997, *The Economist*, June 21–27, 1997.

Figure 5—Italian Unemployment, Inflation, Deficits, and Interest: 1980–1997

Allowing for some caretakers in between, the first real government under the new regime was a center-right coalition, including reformed Fascists, led by the charismatic but dubious Silvio Berlusconi. As various charges caught up with him too, he was followed by a center-left government, including the reformed Communists but also requiring the votes of the unreformed minority. It was headed by the uncharismatic technocrat Romano Prodi. In October 1997, what suddenly appeared to be Prodi's straw house seemed about to blow down when the old-line Communists voted against the austere budget needed to qualify Italy for EMU. Instead, however, popular protest forced the Communists to retreat; Prodi's house proved to be made of Roman marble; and Italy's chances of entering the Monetary Union were, as it turned out, enhanced.

The economic policies of both the new governments, Berlusconi as well as Prodi, began to have striking effects on some of the major indicators shown in Figure 5. Inflation has come down to low French and German levels, and, more important for entry into EMU, the

deficit was cut from 9.76 percent of GDP in 1994 to 7 percent in 1995 and 6.7 in 1996. By decision time in the spring of 1998, the Italians had come into the German/French 3-percent-plus range; they too benefited from the mini-boom in exports. The Germans were still grumpy, but in the final decision, Italy was among the 11 charter members.

The continuing German attitude toward Italy can be illustrated by a story told by the late strategist Herman Kahn. The story (not verbatim) went about like this:

> There was once a man who hated the color blue, although his wife really liked it. She liked it enough, in fact, to paint the kitchen a deep blue. "I can't live with a blue kitchen," said the man, so she relented and painted it a lighter blue. "It's still blue," he said, as he began to pack his suitcase. At this point she really began to understand. She immediately got out her rollers and brushes, and covered the entire kitchen thoroughly with several coats of white paint. "It's still blue underneath," said the man as he went out the door.

For the Germans, the Italians are still blue underneath. They have cut the deficit drastically, they have brought inflation under control, they are reforming their government and economy, but they are still the same irresponsible Mediterraneans underneath. Italian admission into EMU is not going to help the Köhl government in the fall elections.

Within Italy, the consensus wants structural reform of the economy—an end to corruption and a drastic reduction of the regulations, bureaucracies, and taxes that brought about the corruption. In this, the Italians are at almost the opposite pole from the French. Even though Italian unemployment (as measured) is about at the same level as the French, things have gone so far in Italy that public opinion favors reform as a necessity even if it hurts some deserving people. That is why the Communists lost their anti-budget play.

As a result, the Italian consensus also strongly favors EMU membership, much more strongly than do the French or German electorates, because the Italians believe that membership will guarantee the continuation of reform.

THE UNITED KINGDOM

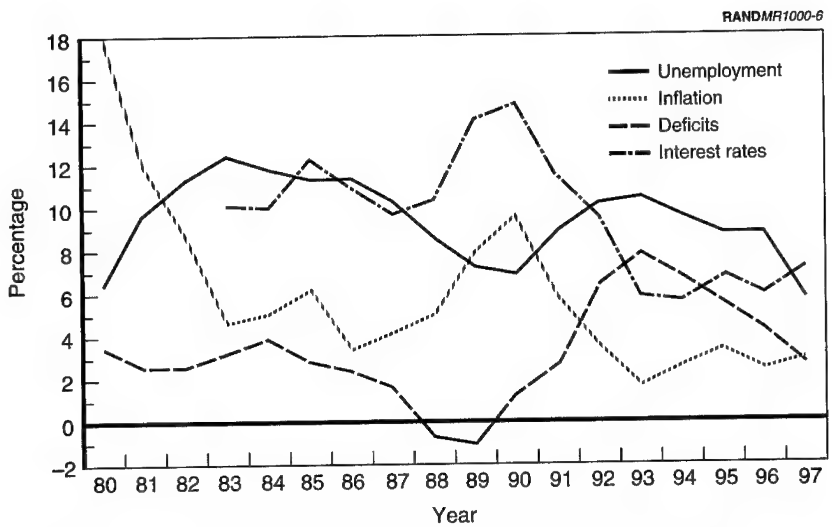
Post–World War II British economic history has two major directional changes that correspond to the 1989–1990 reunification for Germany and the 1994 start of political reform for Italy.

The first break point was the 1972 consummation of Britain's membership in EEC, after a long flirtation. The initial phase of the reluctant romance had ended a decade earlier when de Gaulle vetoed Prime Minister Harold Macmillan's application, and the relationship that did finally begin in 1972 was a union of convenience, not passion. It has continued at arm's length as Britain has stayed out of as many institutions as it could while still belonging to what has become EU. The United Kingdom moved briefly into the Exchange Rate Mechanism (ERM), EMU's predecessor, in 1990, then dropped out and will not join the Monetary Union itself in the first round. Nonetheless, Britain has been a member of EU for a quarter of a century; after a few years of domestic political turbulence after entry, it became clear that the relationship was going to last. More recently, in the late 1990s, the rabid anti-Europeans among the Conservatives proved to be a minority in a minority. Now, Prime Minister Tony Blair's "New Labour" government appears to be proceeding, at a deliberate pace, toward EMU—if EMU works.

The other major change of direction came with the accession of Conservative Party leader Margaret Thatcher to the prime ministership in 1979. Thatcher definitively reversed the postwar trend to nationalization and the welfare state. Although the United Kingdom stayed "in" Europe under Thatcher's reluctant leadership, she moved the British economy away from the highly regulated continental model and toward the flexible high-employment-but-growing-inequality American way. On coming to power in 1997, Blair showed no inclination to reverse or even slow this trend.

Figure 6 charts the two outcome variables—unemployment and inflation—and the two input magnitudes, deficits and short-term interest rates, from 1980, Margaret Thatcher's first full year, to 1997, the first year of the first non-Tory government since her election.

Although the 18 percent inflation rate at the beginning of the period does not in itself explain Thatcher's overthrow of James Callaghan's



SOURCES: For 1980–1995, *OECD Economic Outlook*, June 1996; for 1997, *The Economist*, June 21–27, 1997.

Figure 6—British Unemployment, Inflation, Deficits, and Interest: 1980–1997

Labour government, it illustrates the economic stasis that does provide the explanation. The final year in the chart, 1997, was far better; not only was inflation completely under control, but unemployment was lower than in 1980. The return of Labour after 18 years in the wilderness was not a result of economics, but of Conservative exhaustion, scandal, division, and a running out of the Thatcher ideology without any coherent replacement.

Given the two basic trends that have governed the political economy of the United Kingdom since 1979—into the European system and out of the European ideology—subsequent British economic history can be divided into three periods, with most of the years of the new Labour government being in the future rather than part of that history.

- 1979–1988, *Thatcher takes hold.* Britain began the microeconomic restructuring that formed the core of Thatcherism; macro-

economically, inflation started to drop, but unemployment rose. The deficit even briefly became a surplus.

- 1989–1992, *Thatcher loses her grip.* In 1990, she lost her job, for reasons mostly out of the scope of this discussion, and was succeeded by her Chancellor of the Exchequer, John Major. The period was one of economic turbulence, as an inflationary boom compensated for some of the harsh results of the restructuring. Britain joined the ERM in 1990 partly as an aid to self-discipline, and then had to drop out in 1992.
- 1992–1997, *Major fixes the economy but loses the election.* Dropping out of ERM both enabled the United Kingdom to increase its exports by devaluing the pound and allowed it to run a macroeconomic policy independent of the Bundesbank. The result was a vigorous economy with low inflation and high unemployment. As noted, Major then lost the 1997 election. One enabling reason for the victory of Tony Blair and what he called the New Labour Party was his promise to continue the successful Tory economic policies.

1979–1988: The Thatcher Ascendancy

The first oil crisis of the 1970s had brought down the Conservative government of Prime Minister Edward Heath, who was replaced in 1974 by Labour's Harold Wilson, followed by James Callaghan. It was Callaghan who, in common with the leaders of almost all other western governments, took the punishment for the continuing high misery rates of the 1970s. Aided also by the 1979 "winter of discontent," when strikes by coal miners and others tied Britain into knots, the Conservatives returned to power in the spring of that year.

Thatcher, the new prime minister, was a new-style Conservative. Heath and his postwar predecessors as Conservative prime ministers had implicitly espoused Britain's traditional "Tory Democracy"—an aristocratic government willing to "adopt . . . reforms of a popular character, and . . . to pose as the champion of the masses."[7] In the postwar period, this meant modifying but going along with the wel-

[7] *Encyclopaedia Britannica*, 1952 edition, article on Lord Randolph Churchill, Vol. 5, p. 685.

fare state introduced by the Labour governments of the 1940s and 1950s.

Thatcher, however, was from the middle class rather than the aristocracy, and she embraced a hard-edged free-market ideology that she proceeded to put into practice. Her central means of making the labor market more flexible was by breaking the power of the unions—facing down the miners and changing the laws that had protected the institutional power of trade unions across the board. In addition, the Conservative governments of the 1980s relaxed restrictions on hiring and firing, cut the value of unemployment and other benefits relative to earned wages, and changed the means of setting minimum wages; at the same time, they increased training and public job-placement programs.

The overall effects and effectiveness of these changes has been debated by economists. It has been claimed that, on the one hand, the Thatcher reforms reduced the rate of unemployment at which inflation begins to accelerate dangerously, from 12 percent in the late 1970s to 2 percent in the early 1990s.[8] Certainly, as Figure 6 shows, unemployment slightly above 6 percent in 1980 was associated with an astronomical 18 percent rate of inflation; by the early 1990s, as unemployment dipped back down toward that level after having risen sharply, inflation had dropped into the 4–10 percent range; and in 1997, unemployment dipped below 6 percent, even while inflation had dropped to below 3 percent.

On the other hand, some economists contend that the drop in inflation was based not on increased labor-market flexibility, but on the high unemployment rate maintained during the Thatcher government (from 1982 through 1987, it never dropped below 10 percent), and that the new flexibility in fact did little to change the fundamental relationship between inflation and unemployment.[9]

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[8]P. Minford, "Deregulation and Unemployment—the UK Experience," *Swedish Economic Policy Review*, 1994.

[9]S.G.B. Henry and J. C. Lee, "Unemployment, Wage Dispersion and Labour Market Flexibility," in Jonathan Michie and John Grieve-Smith (eds.), *Employment and Economic Peformance: Jobs, Inflation and Growth*, Oxford University Press, Oxford, England, 1997.

The consensus, in any case, is that the Thatcher government, at least in its early years, did much to break out of the stultifying labor market and other rigidities that had caused the "British disease," and thus set the stage for the current geographic reversal, in which the continent is gripped by *malaise* while the United Kingdom is doing very well by itself, thank you, and is wary of associating itself too closely with the old illness across the Channel.

1989–1992: Thatcher Falters

The problem unsolved—or caused—by Thatcherism was high unemployment. In 1987, it dropped below 11 percent for the first time in four years, but still remained at 10 percent for the year. Since inflation seemed well under control by the mid-1980s, Chancellor of the Exchequer Nigel Lawson moved in the direction of Keynesian demand-side stimulus. Consumption was booming anyhow, and Lawson reduced interest rates below 10 percent in 1987—still high but below the 12+ percent of two years earlier. Tax rates were cut, although the boom made it possible to continue decreasing the deficit. After October 1987, fear of the effects of the stock market crash of that month caused Lawson to increase demand even more.

By mid-1988, however, it was becoming clear that the stimulus was increasing inflation faster than it was reducing unemployment. (This suggests that those who doubted the effectiveness of the Thatcher flexibility were not entirely wrong. With unemployment still high, flexible labor markets should have allowed the stimulus to increase employment without unions forcing wages up.) Adding to the problem, imports were accelerating rapidly and exports were becoming noncompetitive; the British were discovering, as had Mitterrand earlier in the decade, that what was later termed "Keynesianism in one country" did not work very well.

Lawson braked sharply. From May 1988 to October 1989 when he resigned as Chancellor of the Exchequer to be succeeded by Major, interest rates doubled to 15 percent; the deficit became a surplus for two years. By the end of 1990, unemployment, which had dropped to 6.9 percent for that year as a whole, began to rise again.

In October 1990, Chancellor Major tightened Britain's anti-inflationary discipline by joining EU's Exchange Rate Mechanism, which es-

sentially fixed the value of the pound relative to other European currencies, particularly the deutsche mark. The next month, he succeeded Thatcher as prime minister, her departure from 10 Downing Street largely a result of her increasing intransigence on Europe.

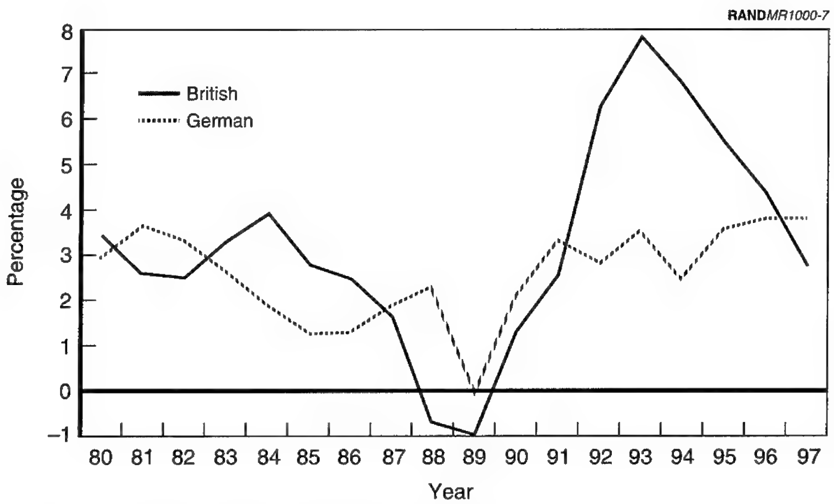
At the same time that Major came to the leadership of the United Kingdom, however, Germany completed its official reunification. As has been discussed, the costs of unification led the Bundesbank to increase interest rates. The deutsche mark strengthened, and to keep from devaluing the pound, Britain would have had to raise its own rates sharply, at a time when the set of anti-inflationary measures had already sent unemployment back up above 10 percent. Rather than do that, the United Kingdom dropped out of the ERM in September 1992, and did devalue, or, more precisely, allowed the pound to float against the deutche mark and other currencies, which led to immediate devaluation.

1992–1997: Major's Economic Victory and Political Loss

It worked. Exports and the balance of payments began to rise again. Perhaps more significantly, having cut loose from European monetary discipline and the Bundesbank, Britain was free for the first time to pursue its own macroeconomic policy, and it did so. Figure 7 shows the British and German deficits as percentages of GDP, from 1980 through 1996. The two tracked one another closely, move by move, for almost the entire period. Suddenly, however, as the United Kingdom broke out of the system in 1992, the British deficit rose sharply. The increase from 2.3 percent of GDP in 1991 to 6.3 percent in 1992 was as much a cause of the departure from the ERM as a result, but the next year the deficit increased further to 7.8 percent before beginning to drop gradually. The government, of course, did not admit to deliberate economic stimulus, but, as put pungently by *The Economist*, it "unleashed an orgy of public spending to bribe its way to victory in the 1992 general election."[10]

And it worked in a manner that was predictable (by Keynesians). Figure 6 illustrated the striking results. Unemployment, which had

[10] *The Economist*, January 4, 1993, p. 60.



SOURCE: *OECD Economic Outlook*, June 1996.

Figure 7—British and German Deficits as Percentage of GDP, 1980–1996

been at 10.1 percent in 1992 and rose to 10.4 percent in 1993, was cut almost in half, to 5.8 percent by mid-1997—this at a time when French and Italian unemployment increased to above 12 percent, and German unemployment rose almost to that level. British inflation continued to hover around the acceptable 3 percent level, lower for the post-devaluation period than in any of the other years since Thatcher had first taken office. (As in the United States, the price for this was apparently increasing income inequality, although inequality is not measured regularly, so it is difficult to pin the increases to those specific years.)

Economic success did John Major no political good, however. After her initial successes, Margaret Thatcher had become an increasingly contentious figure within her own party. Her strident contempt for continental Europe and EU had divided her own party and caused her 1990 replacement by Major, but that did not solve the problems. It was a surprise that Major won the 1992 election; Labour under Neil Kinnock was still not trusted by the great British middle, and the Tories' tax-and-spend warnings were heeded. When Blair took over the

Labour leadership, he determined, à la Bill Clinton, to move to the middle, coopt the Tories' more popular positions, and calm the fears of the electorate. The Conservatives' Euro-splits grew deeper, their scandals stronger, and Major weaker. In May 1997, Blair and Labour won an unprecedented majority in the House of Commons, as the party to continue the prosperity and take it into the 21st century.

The Future

The history of Labour Party economic—and most other—policy since the 1979 defeat started with a sharp turn left and then reversed to gradual movement toward the right over the decade and a half before it finally returned to power. Michael Foot, who succeeded Callaghan as Labour leader, took the party in the direction of true radicalism; after overwhelming electoral defeat in 1983, Foot was followed by a series of ever-more-moderate leaders, culminating finally in victory with Blair.

In economic policy, that meant nationalization under Foot; movement toward more dependence on Keynesianism after the 1983 electoral debacle; the realization from the turmoils of the late 1980s and early 1990s that Keynesianism in one country could not work, and subsequent flirtation with the idea of Euro-Keynesianism; and finally, as Britain became more prosperous under Major, co-option of Tory macroeconomic policies.

Ironically, as the large mid-1990s deficit numbers shown in Figure 7 suggest, the successful Tory policies were at least in part Keynesian, but nobody, either Conservative or Labour, was willing to own up to that. Rather, as the New Labour government took office, it both talked and acted in the neoclassical macroeconomic mode. Two years before the election, shadow Chancellor of the Exchequer Gordon Brown had summarized the platform:

> Labour will be committed to meeting the golden rule of borrowing—over the economic cycle, government will only borrow to finance public investment and not to fund public consumption . . . [We] will keep the ratio of government debt to GDP stable on the average over the economic cycle and a prudent and sensible level. . . . Our emphasis on strengthening the supply-side foundations of the economy, with a sound financial basis for sustainable

> increases in demand, is the route to both low inflation and low unemployment in the medium term.[11]

The emphasis on the "economic cycle" makes this less restrictive and more rational than either the Maastricht criteria and the Stability Pact or the annual budget-balancing that has become the born-again religion at both ends of Pennsylvania Avenue in Washington. It is nonetheless a good distance from active Keynesian macroeconomic policy.

Labour's 1997 election manifesto promised "no uncosted or unfunded spending increases, no concealed tax increases," and Brown's first budget kept to these promises. Perhaps even more significant, his first official act was to abdicate the government's power to set interest rates, which were then implemented by the Bank of England. Rather, the government now sets inflation targets and the Bank manipulates the rates to achieve the targets—a policy interesting not only for its relaxation of government control, but also for its neoclassical focus on inflation as the macroeconomic magnitude of primary concern.

Additionally, the new government made clear, after a small flurry of rumors to the contrary, that the United Kingdom was not going to join EMU in the first round. Perhaps by 2002. Perhaps not.

Most of this is agreed to by British policy economists generally identified with the Labour Party. Recognizing that in the long run, Britain must remain part of Europe, some favor more movement in the direction of EMU. But in general, the economists, like the government, have asked themselves: Why change a policy that has made the United Kingdom the most prosperous large economy in Europe, and has brought Labour back to power to boot? And why tie British economic success to continental failure?

In mid-1998, there were no good answers to those questions. Answers may be needed if or when:

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[11]Gordon Brown, speech to Labour Finance and Industry Group, May 17, 1995, quoted in Paul Anderson and Nyta Mann, *Safety First: The Making of New Labour*, Granta, London, 1997, p. 100. *Safety First* is the major source of most of this brief summary of Labour history.

- The business cycle turns and neoclassicism or mild counter-cylical implicit Keynesianism no longer suffices,
- The drag of the continent slows the British economy, without Britain having any role in setting the policies that might change Europe's macroeconomic direction, or
- Economic malaise causes political turmoil among Britain's neighborhood allies.

Chapter Four

CONCLUSIONS: A WORST CASE AND A BETTER ONE

A WORST CASE: EUROPE, THE WORLD, AND THE UNITED STATES

> Do you not realize . . . that in 1930, 1931, 1932, your predecessor at the Reichsbank precipitated us into the misfortune of massive unemployment because of the same monomaniac deflationist ideology, with the horrifying political consequences that we know?
>
> —Helmut Schmidt, "You Exaggerate, Mr. Tietmeyer!"[1]

Europe

The warning from Germany's last SPD chancellor, Helmut Schmidt, to Bundesbank director Hans Tietmeyer may overdramatize even the worst effects of the wrong kind of EMU, but it makes the point that the EMU of the bankers will control, to a great extent, the economics of workers and businessmen, with potentially traumatic results.

It has been contended here that the worst immediate outcome would be an EMU constrained by a strictly enforced Stability Pact and devoted to wringing the last drop of inflation out of West European economies even at the cost of the kind of deflation Schmidt warns of. The scenario below sketches out some of the economic and political

[1] *Die Zeit*, September 1996. This version was translated from the French republication in *Le Monde*, September 11, 1996.

implications likely to ensue. Schmidt's ultimate abyss, "the horrifying political consequences" of 1933, is not likely, but what the results might be, of the crash of a severe cyclical downturn into an already deflated structure, is a frightening question with unknowable answers.

Even without the cyclical impact, the effects of a rigid and deflationary EMU could be severe, for both Europe and the United States. Within Europe, the consequences could be felt at three levels:

- Across EMU Europe as a whole, unemployment would remain high, perhaps increasing, perhaps decreasing slightly as a result of external and cyclical factors. Scheduled annual conferences on unemployment, in the pattern of the first held in Luxemburg in November 1997, would decry the existing situation and propose ineffectual measures while eschewing any discussion of macroeconomic causes and possible remedies; such discussions would be considered too divisive. The sour situation would bring to a halt further steps toward economic and political integration.
- For better or for worse, the European Union remains an organization of sovereign states. Reaction to a continuing intolerable economic situation would take place within these individual states, where politics would turn inward toward nationalism.
  - In France, as has been discussed, the effects might include street manifestations à la 1968, increasing strength for the proto-Fascism of the *Front National*, xenophobia, or a change of regime.
  - Germany, too, is familiar with xenophobia and nationalism, to which are now added the tensions between *ossis* and *wessis*. These tensions would be exacerbated in this scenario by the grinding to a halt of progress in redeveloping the east, even as the burdens on the west increase. The rift between the two sections would deepen.
  - Italy, not yet in political equilibrium, would receive a strong push back toward instability.
  - The United Kingdom, still out of EMU, would stay out and try to go it alone, turning again away from Europe.

Economically, nationalism across Europe would be matched by mercantilism, which is difficult within an integrated economy and monetary union but by no means impossible, as French farmers and other declining classes frequently demonstrate.

- The common ground on which the individual nationalisms and mercantilisms would meet would be EU-wide mercantilism. The barriers around the existing Union would go up. To the east, admission of the nations knocking on the door would be a receding dream. Further to the east, and to the west, EU would raise its trade barriers against Japan, China, and the other developing Asian economies, and against the United States.

The World

In security and other political matters, Europe's already feeble capability to work as a unit would become weaker still—just as instability in eastern Europe and trade wars with Asia increase the number and scope of *casus belli.* As a result, in this worst-case scenario, the unstable equilibrium of the post–World War II world order would be further destabilized.

The United States

The U.S. interest in avoiding this worst-case scenario for Europe and the world is obvious enough to need no further exegesis. To darken the picture further, however, it is possible to paint in the probable effect on American politics and policy if matters develop in this direction.

It is conventional to say that the danger, if Americans increase their distaste for the rest of the world, is U.S. isolationism. That is not the real danger, however, because it is not possible. Internal American well-being depends too completely upon resources from the rest of the world—petroleum is the prototype but not the sole exemplar; immigration across U.S. land and sea borders is too pervasive and pressing; too many American jobs are export-based. And, transcending all the rest, weapons of mass destruction can be delivered in too many ways, and the possibility of such delivery expands immensely the horizons of terrorism.

Rather than isolationism, as Europe and the world turned nationalist and mercantilist, so too would the United States. The United States is now accused by its allies, as well as its enemies and neutrals, of making too many unilateral decisions for the world, but if the rest of the world becomes increasingly unilateral, the worst is yet to come. Unilateral decision would be matched by unilateral decision; barrier would be matched by barrier.

Fortress America would not be a Maginot Line; it would be a protected-base system—worldwide as much as possible, U.S.-based as much as necessary—from which U.S. power could sortie. The sorties would be made to protect national interests; to protect world and sometimes humanitarian interests (as the U.S. views those interests); perhaps to vent U.S. frustrations. Internally, this would bring about increasing xenophobia (although, interestingly, probably not the increasing racism that sometimes goes with xenophobia—Americans are Americans), and increasing attempts to control life within the United States in order to protect it against life outside the United States. Because of worldwide mercantilism, U.S. activism would have to be carried out with decreasing resources, sometimes decreasing per capita, sometimes, as in the case of oil, decreasing absolutely.

This is not a pretty picture—for Europe, the United States, or the world. True, it is intended to describe a worst case. Aside from the possibility that events simply might not unfold that way, even if they did, they might develop slowly enough that countervailing forces would rise. A small taste of the Stability Pact, for example, might cause the Pact's collapse and the reversal of EMU toward expansionary policies. On the other hand, however, the steady decline described in the scenario is not the truly worst case. A cyclical crash could bring about a *really* worst worst case, à la Schmidt.

Yet, as was noted earlier, muddling through with EMU is more likely than the strict-Stability-Pact worst case. Even muddling through, however, could turn out to be a worsening case, eventuating ultimately in the worst.

A BETTER ALTERNATIVE

> [W]e have developed some serious qualms about the way in which Emu [sic] is taking shape and the narrow definition of its responsibilities and objectives. The root cause of our concern is unemployment.... [A] big cause... lies in the behaviour of aggregate demand... We agree that labour rigidities may contribute to the unemployment problem in the EU and that they deserve attention. But they are certainly not the only cause and may not even be the main one.... The time has come for a drastic change of policies for the [next] phase of Emu. A plan should be drawn at the European level setting a target for employment to be pursued through a gradual but significant increase of total investment, private as well as public.
>
> —Franco Modigliani and Giorgio La Malfa[2]

What Is Needed?

Muddling through will not help solve the problems of unemployment and growth. A conservative monetary policy, a partially enforced Stability Pact, and quarrels exemplified by that between Germany and France over the ECB presidency will make difficult both short-run action to combat deterioration and long-run structural change. As Nobel Prize winner Franco Modigliani and Italian political leader Giorgio La Malfa contend, a more active alternative is called for.

Monetary Union is not an impediment to such action; because of the impossibility of monetary or fiscal stimulus in one European country, EMU is in fact a necessity. And stimulus, with the consequent near-term acceleration of growth and reduction of unemployment, is in turn a political requirement for long-run structural change.

Monetary Union does not require the Maastricht criteria as written; it certainly does not require their perpetuation through the Stability Pact. Current devotion to the conservatism embodied in these documents parallels the devotion to the gold standard in the 1920s. In 1925, Keynes predicted disaster from the post–World War I return to

[2]"Perils of Unemployment," *Financial Times*, January 16, 1998, p. 18.

gold;[3] in 1929 he was proved correct. In 1935, the title of his seminal work, *The General Theory of Employment, Interest, and Money,* showed the order of his priorities (and the world's at that time).

The oil crisis of the 1970s did away not only with Keynesian policies but with the priority on employment as well. Perhaps it is now possible for Europe to return to that priority and to economic policies focused on reducing unemployment.

"Keynesianism in one country" has become impossible, at least for one small country; Keynesianism on one continent may or may not be possible. The very large and wealthy economy of Western Europe might be able to revive itself without cooperation from the rest of the developed world—if in no other way, by building walls of autarchy—although it would be far better and easier to do so in cooperation with Japan and the United States.

The current condition of Japan is such that even economists who dismiss fiscal stimulus for the United States and Europe now recommend it for Japan; whether the recommendation will be accepted and implemented remains to be seen. For the United States, the stake discussed above is large. The American and Japanese roles in reviving European economies and improving their own require another body of analysis.

For all three of the partners in the triangle of the developed world, a change in macroeconomic direction can be crucial. A change in EMU may not be sufficient for a new world direction, but it is surely necessary.

But Is It Possible?

"Necessary" and "possible" are not synonyms. When something is absolutely necessary and absolutely impossible, disaster ensues; in this case, it could be the disaster illustrated by the scenario. And on the face of it, the alternative suggested here seems simply not politically possible under current circumstances.

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[3]John Maynard Keynes, "The Economic Consequences of Mr. Churchill," *Essays in Persuasion,* Norton, New York, 1963.

However, current circumstances may be misleading; in this case, the past may be a poor guide to the future. An employment-targeted EMU may become a real political contingency. Maastricht and the Stability Pact were developed when three of the four major economies were governed by conservatives and Italy's was not governed at all. By mid-1998, however, three of the four were governed by moderate leftists, and it seemed possible that in less than six months, Germany would be too.

The German election is one key to change; the other is Tony Blair and New Labour in the United Kingdom. British historian/journalists Paul Anderson and Nyta Mann contend that

> There is still a strong case for believing that the European Union post-EMU will have the economic weight to pursue Keynesian demand management at a supranational level . . . Labour will have to be pressed on this, at the very least to work with the new French government and other continental social democrats on developing the role of the European investment bank and on pushing for Europe-wide infrastructural projects.[4]

Anderson and Mann are somewhat to the left of Blair in the Labour Party, and perhaps more optimistic about Euro-Keynesianism than is warranted. Yet Labour is a party of the left, and it may be, as they suggest, that the party may be willing to work with similar parties on the continent to prevent a disaster that could then move back across the Channel to Britain itself.

Lacking such a reversal of current directions, however, EMU, Europe, and the world may well enter the 21st century in a precarious position, subject to economic upset and political turmoil.

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[4]Anderson and Mann, p. 387.